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IN THE

Supreme Court of the United States

OCTOBER TERM, 1934

No. 648

HAROLD E. WEST, J. FRANK HARPER AND STEUART PURCELL, CONSTITUTING THE PUBLIC SERVICE COMMISSION OF MARYLAND, APPELLANTS,

vs.

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF BALTIMORE CITY, APPELLEE.

Appeal from the District Court of the United States for the District of Maryland.

BRIEF ON BEHALF OF APPELLANTS.

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Appeal from the District Court of the United States for the District of Maryland.

BRIEF ON BEHALF OF APPELLANTS.

STATEMENT OF THE CASE.

This case comes up on direct appeal from a final decree of the District Court of the United States for the District of Maryland under the provisions of Section 266 of the Judicial Code, 28 U. S. C. A., Section 380. Probable jurisdiction was noted on February 4, 1935.

The Appellants, who are the persons constituting the Public Service Commission of Maryland (hereinafter called the "Commission"), instituted on January 19, 1933, an investigation of the rates and charges of The Chesapeake and Potomac Telephone Company of Baltimore City, the Appellee (hereinafter called the "Company"), and hearings before the Commission were begun on May 2, 1933. Testimony was taken for thirty-six days, and after a period of several weeks allowed for the preparation of argument, five more days were consumed in argument, and the case was submitted to the Commission on September 18, 1933. On November 28, 1933, the Commission filed an order, which is in issue in this case, reducing the Company's rates for 1934 and until further order, and also filed an exhaustive opinion (I, 13-79. The record is in two volumes; references will be made to volume and page).

On December 13, 1933, without waiting for a test period of the new rates, the Company filed a bill for a temporary and permanent injunction in the District Court to restrain the Commission from putting its order into effect (I, 1-9). The temporary injunction having been granted, the case was heard before a Statutory District Court, consisting of Circuit Judge Soper and District Judges Coleman and Chesnut, without reference to a master. The trial took place in March, 1934, and was completed within two weeks. The opinion and findings of the District Court were filed on May 11, 1934 (I, 529-585), and on June 8, 1934, a final decree was signed restraining the Commission as prayed in the bill of complaint (I, 587). The lower Court's opinion is reported as *Chesapeake & Potomac Telephone Company vs. West*, 7 F. Supp. 214. By stipulation the hearing before the three Judge Court was on both the temporary and permanent injunction. The Commission applied for and was allowed this appeal on July 13, 1934.

From evidence offered before the Commission, and from further study by the Commission and the Company, a segregation between interstate and intrastate business was arrived at, and in the trial before the District Court the parties accordingly by stipulation agreed, and the Court found as a fact, that 85% of the total property, revenues and expenses of the Company in Maryland was attributable to intrastate business (I, 98). Thereupon, with the consent of the surety on the Company's injunction bond, the Commission filed an amended order *nunc pro tunc* on April 2, 1934, amending its order, in accordance with this determination, to effect a reduction of $850,000 in the intrastate net revenues of the Company, instead of a reduction of $1,000,000 in the total net revenues (I, 81). The testimony and exhibits, both before the Commission and the District Court, were in terms of total property, revenues and expenses of the Company, and consequently, to avoid confusion, the case will be so presented to this Court. Inasmuch as the percentage for intrastate business is uniformly 85%, the practical effect is the same whether 85% or 100% is considered.

A general summary of the facts pertinent to this Court's determination of the appeal will be stated, although it will be necessary in the course of argument to refer to certain parts of the record in more detail.

The Commission in the latter part of 1932 and early in 1933, held a series of conferences with the leading utilities in Maryland in an effort to secure immediate and voluntary reductions in rates, as the Commission realized that formal hearings in all such cases would require years of time and great expense. At that time the current economic depression, which had started in 1929, had already run for three years and was definitely recognized as not a mere temporary slump in business activity but, as this Court had described it, "a changed economic level". The Commission believed that substantial reduc-

tions in utility rates were indicated in justice to the public. In the case of the Telephone Company, however, this informal negotiation was unsuccessful, and accordingly the Commission instituted the investigation previously referred to. (See Commission's opinion, I, 14-15).

The Commission was created by statute in 1910 and since that time, through formal rate hearings and through routine reports and otherwise, has been in close and constant touch with the Company in matters affecting its operations. The three most important formal hearings prior to 1923 were in 1916 (II, 923), 1920 (II, 1029), and 1924. The 1916 case was at the time considered a landmark in state utility regulation, and it was hoped that the rate base then established could be brought up to date readily at any subsequent time by the inclusion of net annual additions to plant at cost, and that expensive and laborious hearings would be thus eliminated. In 1924, however, the Company, as was its lawful privilege to do, became dissatisfied with the basis established in the 1916 case, and on its own motion applied to the Commission for increased rates. The Commission thereupon conducted a full hearing and determined fair value and fixed a rate of return of 6%. The Company sought an injunction from this determination before a three judge Statutory Court in the District of Maryland, presided over by the late Circuit Judge John C. Rose. The case was tried before that Court in 1925 and the exhaustive and searching opinion written by Judge Rose is reported as *Chesapeake and Potomac Telephone Company vs. Whitman*, 3 F. (2d) 938. As the method of valuation used by the District Court in that case is similar to the method of the Commission in the present case, a brief summary of the Court's findings in 1925 will be indicated.

The Commission's finding of fair value in 1924 as of 1923, was $24,350,000, and though not based on historical cost, the valuation of plant, including going value, was

actually about $2,000,000 more than net cost. The Company introduced before the Court in 1925, as evidence of fair value, two complete appraisals,—one in excess of $42,000,000 and the other in excess of $37,500,000. The Company also put in evidence, through Dr. Jacob H. Hollander, the distinguished economist of The Johns Hopkins University, the U. S. Bureau of Labor Statistics All Commodities Index of Wholesale Prices, to confirm the upward trend of prices indicated by the Company's appraisals, and also to confirm the corollary fact that the purchasing power of the dollar was relatively low as compared with the dates of the Commission's two previous determinations of rates as of 1914 and as of 1919. (See 3 F. (2d) at 946-7). The District Court, while rejecting the Company's appraisals as grossly excessive and conjectural, was convinced that fair value, in the light of the increase in price levels, should be substantially higher than the Commission's value, which was in turn higher than net historical cost. The Court's final fair value was $29,500,000, which was $5,000,000, or approximately 21%, higher than the Commission's fair value.

The District Court arrived at its valuation as of 1923 as follows: It first took the 1914 gross cost, plus the Commission's allowance for going value, and by relating the Bureau of Labor Statistics All Commodities Index number for 1914 to the corresponding index number for 1923, "trended" or translated the dollars of 1914 into the higher price level of 1923; the Court included working capital in this trending process because it trended total assets. Having thus translated the 1914 dollars into terms of 1923 dollars, it pursued the same method with the net annual additions of assets of the Company for each intervening year, respectively, starting with 1915, and separately trended those net annual additions up to the 1923 price level by the use of the

Bureau of Labor Statistics All Commodities Index numbers. The Court did not, however, disturb the Commission's finding of 6% as a fair rate of return.

The Commission thereupon cheerfully accepted Judge Rose's opinion and filed a new order establishing rates for 1924 based on the District Court's fair value. The Company has been earning on the high value so established, plus annual net additions at cost, ever since 1924, including the four depression years from 1930 through 1933. The Company did not, in 1925, appeal from this subsequent order of the Commission, nor has it requested increased rates since that time, although it now contends that it has been operating under confiscatory rates from 1924 through 1933; and the Company's evidence in the present case, if accepted, *would actually result in a large increase in rates for* 1934.

To throw light on this solemn contention of the Company that it has suffered from "confiscation" since 1924, it is interesting to note briefly a few facts about its history during this period. On its average gross cost of plant in service, undepreciated, it earned, according to its own evidence: in 1924—4.71%, 1925—6.36%, 1926—6.98%, 1927—6.08%, 1928—6.62%, 1929—6.71%, 1930—6.54%, 1931—6.85%, 1932—5.78% (I, 611). By way of enlightening comparison, the Illinois Bell Telephone Company, which was recently before this Court in the *Lindheimer Case*, 292 U. S. 151, on the same basis earned only 4% in 1932, *prior* to the reduction in rates sustained by this Court (II, 918).

Since 1923 the Company's common stock, all held by The American Telephone and Telegraph Company, has increased from $17,000,000 to $30,000,000 (I, 597). Dividends totaling $17,000,000 have been paid, represented by the following rates: 1924—6%, 1925 through 1932—8%, 1933—7% (I, 386). In spite of this extraordinary disbursement in dividends, the Company's general sur-

plus has risen from $1,000,000 to $2,250,000, and the surplus allocated to depreciation reserve has increased from $6,439,796 to $11,483,357 (I, 387, 597-9). Moreover, the gross cost of plant has increased from $28,000,000 to $50,000,000, even though retirements during the period have been in an amount of over $20,000,000 (I, 387). The Company also has $3,000,000 of 7% preferred stock in the hands of the public, which is callable at 110, but is now selling well above that price (I, 387). The Company's rates have *never been decreased by Commission order* until the present case, but have steadily increased (I, 113-114).

It is against the background of this unique record of splendid achievement that the Company now actually offers to prove that it would be constitutionally entitled to an *increase* of rates for 1934. While the ten years from 1924 to 1933 are not in issue in the present case, such fantastic proof illustrates again the vice of exaggeration which the Chief Justice noted in the *Lindheimer Case*, 292 U. S. 151, at 175.

The Commission in its findings in the present case, as set forth fully in its opinion, took as a starting point the method of determining fair value used by the District Court in 1925, observing that it was constrained to do so by the authority of that Court. The Commission also accepted the clear law established by this Court, that fair value fluctuates and thus may be more or less than cost, depending on circumstances. Before the Commission the People's Counsel offered in evidence in addition to the U. S. Bureau of Labor Statistics All Commodities Index, substantially all of the recognized and reliable indices of prices and other indications of business activity, and these were described, analyzed and applied by the Commission's Chief Auditor. The Company offered two evidences of value before the Commission,—one based on cost and the other based on a com-

bined inventory and appraisal somewhat similar to the reproduction cost method. In the latter method the Company also used index numbers of its own preparation, which were applied to a substantial portion of the plant. The Company's evidence of gross cost of fixed and intangible property indicated a 1933 value of $49,931,946.57 (I, 601), and the so-called reproduction cost less depreciation in condition indicated $48,144,672 (I, 18).

From the 15 basic indices offered before the Commission, which included building construction, commodities, labor costs, railroad telephone construction, and costs of other articles and services for which net return in dollars is customarily exchangeable, the Commission developed a weighted index which gave effect as far as possible to the many and varied elements which go into telephone properties. It gave effect also to commodity indices as a reflection of the purchasing power of the dollar, as the Company had done in introducing the All Commodities Index in the 1925 case in the District Court, when price levels were relatively very high. The Commission, however, though it recognized the authoritative nature of the All Commodities Index, sought to check and confirm it with the other standard indices. We believe it thus developed a more accurate and better controlled criterion than that used by the District Court in 1925.

The Commission then applied to the dollars of the 1923 fair value, including going value, as found by the District Court, the appropriate weighted index number for 1923 related to the corresponding index number for 1932, and did the same for net additions in each intervening year in substantially the same manner pursued in the 1925 case by the District Court, except that the Commission, instead of trending total net assets, trended net physical additions to plant. It treated working capital as a separate item for which a separate determination

was made. The Commission thus arrived at the 1933 gross value of the Company, less working capital, as of December 31, 1932. The Commission then trended to current dollars in similar manner the depreciation reserve of the Company, which brought it to 18.4% of the gross value of plant in December, 1932, and this amount was deducted as the best, and in fact the only evidence of impairment in value, to reach the depreciated present value of the physical assets. It then added its finding of a proper allowance for working capital. The aggregate figure so reached as fair value of the Company's entire property for 1933 was $32,621,190 (I, 76).

In applying its index numbers to annual net additions since the 1923 valuation, the Commission necessarily had to accept the Company's costs, as reflected on its books, for both materials and labor. This was done in spite of the 10% increase in the Western Electric Company's prices to the Bell Companies effective November, 1930, and in spite of the Telephone Company's high labor rates. Both of these increases were, of course, notoriously contrary to the universal experience of all other business the world over, which was at this period plunging down into the "changed economic level". The explanation for the anomaly of this increase of prices is obviously that the A. T. & T., owning both the Western Electric Company and the Bell Companies, can at will establish subjective prices which are not influenced by objective and competitive conditions. This was frankly what was done. Since the "competitors" of the Western Electric are admittedly negligible and powerless (I, 181), it is not possible for this Commission or any other governmental body to ascertain with any confidence of accuracy, what are fair competitive prices to be paid to the Western Electric by other subsidiaries of the A. T. & T. *as a basis for public regulation.* (This question will, of course, be considered fully in argument.)

The Commission allowed 6% as a fair rate of return, notwithstanding the fact that this was the same rate which had been allowed for 1924 and subsequent years by the Commission and the District Court at a time when returns in all types of business, including utilities, were far higher than in 1933.

The net return to the Company resulting from the Commission's findings of fair value and the rate of return of 6% (*i. e.*, 6% of $32,621,190) would have been $1,957,271. The Commission estimated that the Company's net return for 1933 would be $3,353,793; in this estimate the Company's figures were used for all items except depreciation expense and taxes. The Commission allowed a substantially lower amount for depreciation expense than was claimed by the Company, and accordingly increased the item for income taxes to make adjustment for the increased net return resulting from the reduction in the depreciation expense (I, 76). *The Commission did not, however, fix a net return to the Company for 1934 on the mathematical basis of its fair rate of return on its fair value.* It noted the promise of an upturn in prices as reflected in the All Commodities and other indices since December 1932, and also took hopeful notice of the efforts of the Federal administration further to raise general price levels. Accordingly, instead of ordering a reduction in the rates of the Company in the amount of $1,396,522, which was the difference between the estimated return of the Company for 1933 ($3,353,793) and the return resulting from the Commission's fair value and rate of return ($1,957,271), it ordered a reduction of only $1,000,000, thus specifically and expressly allowing to the Company a margin of $396,522, to give the Company the benefit of all the existing uncertainties as to future business conditions generally, and to forestall any suggestion that the Commission was hewing too close to the line. (See I, 17 and 77.) For some reason

which we are unable to understand, the District Court in its opinion in this case *entirely overlooked and even failed to mention* this action of the Commission in allowing such a substantial margin of net return.

It will be seen that the practical result of the Commission's action is therefore to allow to the Company a net return of $2,353,793, representing a reduction of $1,000,000 from $3,353,793, which was the estimated net revenue of the Company for 1933. It is important to recall that these estimated revenues were based on the Company's figures, and that as the only difference between the Company's estimate and the Commission's estimate is in the allowance for depreciation expense, there is no other controversy about the estimate.

It may also be noted that a capitalization of the actual net return in dollars allowed by the Commission at 6% indicates an effective rate base of over $39,200,000, instead of the fair value as of December, 1932, found by the Commission in the amount of $32,621,190. (See comment of the Chief Justice in the *Lindheimer Case*, 292 U. S. 151, at 164). While this is not completely accurate without making minor adjustments, yet, in view of the District Court's finding of a rate base of $39,541,921.27, and a fair return of 6% thereon, or $2,372,515 (I, 584), it illustrates how nearly the Court and Commission arrived at the same result in all essentials, except depreciation expense. When one notes that this 1934 value of the District Court *is actually based on historical cost*, though up to 90% of the property was admittedly installed during the period of high price levels before the depression (I, 391-393), the generosity of the Commission is apparent. Of course, the margin of $396,522 allowed in excess of the Commission's findings of the rate base and rate of return, need not be applied to rate base. It could be used as excess operating income or return. We have suggested its effect on the rate base merely for comparison.

The Commission, as indicated, trended the Company's depreciation reserve to present value and deducted it from gross value to reach fair value, as it believed that this trended reserve was the best, in fact the only, evidence offered of actually existing impairment in *value*. The Company's evidence, introduced through Mr. W. F. Sloan, was of observed impairment in operating efficiency only, and expressly did not include an estimate of impairment in *value* (I, 274).

The Commission accepted the Company's claim for operating expenses in full, except for depreciation expense. In the determination of annual depreciation expense the Commission followed the familiar "straight line" method, finding separate rates to be applied to each class of depreciable property by dividing the gross value of the property, less estimated salvage, by its estimated service life in years. It found the estimate of service lives made by witnesses for the People's Counsel to be too long, and the estimates of the Company's witnesses too short. It also took into account the retirement experience of the Company, and the fact that the important element of inadequacy of facilities as a factor of current depreciation, cannot be operating in a plant which is not growing, but which has instead a substantial excess or "overadequacy" of plant facilities due to the heavy loss of subscribers since the depression. The Commission found its own rates as a question of fact and applied them to the gross value of each class of depreciable property (I, 61). The District Court in its opinion (I, 574) erroneously states that the Commission's rates were applied to depreciated values. The allowance of the Commission for depreciation expense, in dollars, was $1,352,284, as contrasted with the Company's claim for 1934 in the amount of $2,173,000 (II, 797), and the District Court found $2,000,000 (I, 584). It is important to note that the Commission made this allowance

without reference to the size of the Company's existing depreciation reserve, but relied on the opinions of the engineers as to present service life conditions, realistically reviewed in the light of the Company's experience of retirements in previous years.

Before the District Court the evidence on both sides was substantially the same as before the Commission, though much of it was radically condensed to permit completion of the case within the limited time at the Court's disposal. The Company also put in additional evidence of experts to challenge the validity of the Commission's use of index numbers in arriving at value; and of course such testimony as was affected by the lapse of time was brought up to date. (The 1934 results are available also from the Company's reports to the Commission, though they are not, of course, in the formal record. They are furnished separately in an Appendix to the Commission's brief if the Court feels it is desirable and proper to consider them.)

The District Court held, that while the Company's composite valuation, which is referred to as reproduction cost, was excessive and conjectural, historical cost less depreciation was the minimum non-confiscatory rate base, —even though the property was demonstrably and admittedly purchased at higher prices than those prevailing on the effective date of the valuation. While it purports to find "present fair value", the District Court plainly states that it is convinced that the prudent investment theory, so persuasively set forth by Mr. Justice Brandeis in the separate opinion in the *Southwestern Bell Telephone Case*, 262 U. S. 289-312, should apply not only to present circumstances, but future determinations of rates (I, 553-554, 581).

The present District Court criticizes the Commission for following Judge Rose's opinion in the 1925 District Court case, and attempts to distinguish the circum-

stances (I, 568). The Court argues that general price indices do not, except by coincidence, express the fluctuation in value of "specialized" property—such as the enormous number and variety of items which enter into a telephone plant. Thus, brushing aside the Commission's thoughtful and carefully prepared valuation, and frankly embracing the prudent investment theory, the Court *automatically* holds the Commission's stated fair value of $32,621,190 to be confiscatory. In so doing the Court overlooks the margin of net return specifically allowed by the Commission, to which we have already referred, and which materially qualifies the Commission's finding of value, even if it could be regarded as too low considered separately. In other words, the practical result of the totality of the Commission's action is not only disregarded, *but is not even mentioned.*

Having thus laid aside the Commission's deliberated findings, and not even noting the Commission's generous additional allowance, the District Court pursues item by item its own independent findings, feeling expressly justified in so substituting its judgment by the language in *Ohio Valley Water Co. vs. Ben Avon Borough*, 253 U. S. 287, to the effect that a court must exercise in such cases its independent judgment. Of course, as will be argued fully, this familiar and long-standing doctrine does not justify judicial rate-making in the absence of coercive proof that the Commission's action is necessarily confiscatory.

The District Court's finding of physical and intangible value is gross cost less the depreciation reserve, or $38,541,921.27, to which it adds the arbitrary figure of $1,000,000 for working capital. It approves the Commission's rate of return of 6%, and so arrives at a fair return of $2,372,515 (6% of $39,541,921.27), as contrasted with its estimate of actual 1934 return of $2,742,005 (I, 584-5), and as compared with the Commission's allow-

ance of return of $2,353,793. The Company claimed for 1934 a return of not less than 7½% on a value of about $49,700,000 (II, 798), or more than $3,700,000, which is about $980,000 higher than the Court's estimated return for 1934. It is $1,200,000 more than the Company earned in 1933 (II, 797).

We have stressed the comparisons of net return in dollars to emphasize as a matter of fact the critical importance of the allowance for depreciation expense. Obviously, if the Commission's finding of this item has not been convincingly proved by the Company's evidence to be beyond the Commission's broad discretion in such matters, it follows that the District Court's decree must be set aside, *even if the Court's value can be sustained,* as this item of depreciation expense represents the only practical difference in final result between the District Court and the Commission.

However, while the issue on appeal *may* thus be technically narrowed to one item, the Commission respectfully represents that it has come to this Court, not as a jealous litigant seeking a private material advantage, but rather as an impartial governmental body, which has previously made its own determinations and which is seeking to be advised as to its proper course in future regulation of all the utilities in its jurisdicton. The Commission represents that without the authoritative determination of this Court, the law of valuation in the District of Maryland is now an intolerable inconsistency. Plainly stated, the District Court's decision in 1925 reversed the Commission's finding of a value in excess of cost, and reached a value 21% higher because price levels were high. The same Court in 1934 reverses the Commission, which followed the Court's 1925 method, and announces that net cost, *in times of low prices,* is the minimum non-confiscatory rate base. This means that in Maryland a utility is entitled to earn on fair value or

not cost whichever is higher. The Commission's method of finding value, therefore, while not necessarily a turning point in this appeal, is of the utmost importance in determining for its future deliberations whether the Commission has in this case made a fair determination of value, or whether the present double standard for utilities is to be perpetuated in Maryland.

SPECIFICATION OF POINTS TO BE ARGUED.

The Commission will argue all of the contentions comprehensively stated in the Assignment of Errors (I, 589), as re-stated and sub-divided in detail according to subject-matter in the Statement of Points (II, 1093). To facilitate this Court's consideration of the case as a whole, the order of the points is somewhat rearranged in argument, repetitious technical phraseology is omitted, and appropriate subject headings are inserted. The one basic issue in a rate case such as this is whether or not the Company has clearly proved by compelling evidence that the total effect of the Commission's action necessarily results in confiscation. That comprehensive issue runs through all of the separate points, which are therefore largely interdependent. It is thus necessary in argument to treat several of the points together under subject-matter headings; and furthermore, not even the subject-matter headings can properly be regarded as independent issues without reference to their bearing on the one main issue. As the points relied on are given in considerable detail, the following enumeration of them will also provide a convenient outline and summary of argument.

SUMMARY OF ARGUMENT.

I. The Practical Result of Accepting the Company's Proof.

The proof of value and rate of return offered by the Company would, if accepted, necessitate a finding that the Company has been operating under confiscatory rates from 1914 through 1933, and that its rates must be very substantially increased for 1934. Such proof is contrary to the Company's experience and other proven facts.

II. The Practical Result of the Commission's Action.

The fairness of the Commission's total action is demonstrated by its practical effect on the Company's rates.

(a) Even on the assumption that the District Court's excessive and independent valuation was correct, the reduction ordered by the Commission was fair and reasonable.

(b) The net return allowed by the Commission is not only more than a fair return upon fair value, but is also adequate to meet all of the reasonable requirements of the Company, over and above operating expenses, for interest, dividends, and other fixed charges, and to provide an additional amount for surplus.

III. Depreciation Expense.

The Court's arbitrary finding of $2,000,000 as the minimum non-confiscatory allowance for annual depreciation expense was excessive and erroneous.

(a) The Commission's allowance for annual depreciation expense was a finding of fact, was based on substantial evidence, and was demonstrably fair

and liberal under the conditions indicated by the testimony.

(b) The Court erred in failing to give proper weight to the uncontradicted evidence of the change in economic conditions, which has substantially suspended for an indeterminate period of time in the future the current operation of inadequacy as a factor of currently accruing depreciation, which factor was, under previously existing conditions, the largest single cause of such depreciation.

(c) The rate and amount found by the Court were arbitrary round figures, based on no specific evidence as applied to separate items of depreciable property.

(d) The Court erred in substituting its judgment for the judgment of the Commission, because the proof of the Company was lacking in the force legally required to establish that the Commission's finding was clearly wrong.

IV. The Commission's Valuation.

The Commission in finding fair value gave effect both to cost when incurred and to present value, and considered every other element of value required by law, and the value so found was fair and reasonable and supported by substantial evidence. The method of valuation used by the Commission was substantially that used by the District Court itself in the previous case involving the same parties in 1925.

(a) The Commission's valuation of the physical plant accepted actual investment at cost when in-

curred and referred such dollars of investment to current value.

(b) The Commission's allowance for going value was fair and reasonable.

V. Accrued Depreciation.

(a) The Commission's deduction for accrued depreciation was fair and reasonable and was based on substantial evidence, and in fact the only evidence offered of impairment in value.

(b) The amount deducted for accrued depreciation in the Company's proof was admittedly insufficient to include all factors of such depreciation.

VI. Working Capital.

The Court erred in finding and including as a part of the rate base, working capital in the amount of $1,000,000.

(a) The amount allowed by the Commission for working capital was a finding of fact based on substantial evidence, and was fair and liberal.

(b) The amount claimed by the Company for working capital was erroneously computed and was excessive.

(c) The amount found by the Court was an arbitrary round figure and based on no specific evidence.

(d) The Court erred in substituting its judgment for the judgment of the Commission, because the proof of the Company was lacking in the force legally required to establish that the Commission's finding was clearly wrong.

VII. The Commission's Liberal Allowance of Operating Expenses.

The Court erred in failing to give any or proper weight to the allowance by the Commission to the Company of liberal operating expenses, the disallowance of which would have been fair, reasonable and non-confiscatory.

(a) The Commission allowed in full as operating expenses the amounts payable by the Company to the Western Electric Company for maintenance and other items, notwithstanding abnormal and unreasonable increases in Western Electric prices.

(b) The Commission allowed as operating expenses the full amount of the Maryland capital stock tax, although it is a tax on stockholders on their shares and not a direct tax on the Company's property.

(c) The Commission allowed as operating expenses in full the labor rates of the Company, although the evidence showed that such rates were higher during the years of the depression than immediately prior thereto.

VIII. Independent Valuation by the District Court.

The Court erred in finding that the minimum non-confiscatory rate base of all of the Company's property used and useful in rendering telephone service, as of December 31, 1933, was $39,541,921.27.

(a) The Court's finding was admittedly based on historical cost, which it found to be the same as prudent investment, although the evidence showed that by far the greater portion of the plant was

installed during a period of higher prices than those prevailing on the effective date of the valuation.

(b) The Court erred in assuming in its opinion that the cost of the Company's property had been incurred at times and under circumstances and at price levels not greatly dissimilar from those prevailing at the time of the hearing and likely to prevail in the near future.

(c) The Court erroneously accorded "special weight" to historical cost, being led to do so by an erroneous interpretation of the "history of the relations of the Company and the Commission," and of the history of former rate cases involving the Company, and by an erroneous application of such erroneously construed and irrelevant history to the circumstances of this case.

(d) The Court erred in failing to accord any or proper weight to the evidence of decreased costs of labor and materials prevailing at the time of the hearing, as compared with the costs prevailing at the times the properties were acquired.

(e) The Court failed to give effect to the liberality of the Commission, not required by the evidence, in allowing in the fair value fixed by them, a substantial excess of plant over and above present requirements for service. (Discussed under IX, d.)

(f) The Court erroneously included in its findings property owned by the Company but not used and useful in rendering telephone service. (See IX, d.)

IX. The Company's Evidence of Reproduction Value.

The Company's evidence of value, based on a method of appraisal purporting to show reproduction cost, was

founded on hypothetical calculations and was so grossly in excess of the fair and reasonable value, and *a fortiori* the minimum non-confiscatory value, as to deprive it of much of its evidentiary weight and probative force.

(a) The Company's composite index reveals the exaggeration in the Company's reproduction cost valuation.

(b) The Company's appraisal of buildings confirms the applicability of the All Commodities Index as a measure of such values.

(c) Explanation of the Company's several procedures in valuation.

(d) The valuation included a large amount of property not used and useful in rendering service, which could have properly been, but was not, eliminated by the Commission.

(e) The Company's appraisal of physical property discloses a host of arbitrary and erroneous assumptions.

(f) The value claimed by the Company was based, at least in part, on the unreasonably high prices for material charged by the Western Electric Company.

(g) The "undistributed construction costs" included in the Company's value were conjectural, uncertain, based on no specific or substantial evidence, and were grossly in excess of the actual cost of such overheads in the existing plant of the Company.

(h) The cost of labor used in the Company's appraisal was greatly in excess of its market value.

(i) The element of going value included in the Company's value was conjectural, uncertain, based on no substantial or specific evidence, and was grossly in excess of the actual cost of establishing such value in the Company's present plant.

(j) Conclusion on Company's valuation.

X. Rate of Return.

The Court erred in finding "that a return of less than 6% would be confiscatory under present conditions", and in giving no weight to the Commission's allowance of 6%, even though the evidence justified an allowance of 5½% as reasonable and non-confiscatory.

(a) The evidence shows that a return of 5½% would support the Company's credit and enable it to attract all necessary capital.

(b) The evidence shows that a return of 5½% would compare favorably with returns being made at the same time by other enterprises attended by corresponding risks.

(c) The Court erred in failing to give any weight to the effect of the decrease in general price levels which increased the purchasing power of the dollars of current net return as contrasted with the purchasing power of the same number of dollars prior to the depression.

(d) The Court erred in failing to give any weight to the fact that the subscribers to telephone service, because of decreased income, are now paying a larger proportion of such income for such service as compared with the period prior to the depression, the said rates being the same in dollars.

XI. Conclusion.

ARGUMENT.

I. THE PRACTICAL RESULT OF ACCEPTING THE COMPANY'S PROOF.

The proof of value and rate of return offered by the Company would, if accepted, necessitate a finding that the Company has been operating under confiscatory rates from 1914 through 1933, and that its rates must be very substantially increased for 1934. Such proof is contrary to the Company's experience and other proven facts.

In the Company's Bill of Complaint it is alleged that the *present* return on fair value, prior to the reduction ordered by the Commission, was 5.0% in 1933 (Paragraph VII; I, 5). It is further alleged that a *fair* return upon fair value it not less than 7.5% (Paragraph X; I, 6). The Company's Chief Auditor, Mr. Gretz, also stated that in his opinion the Company had been earning less than 6% on fair value ever since 1914 (I, 526). The Company's formal evidence indicated a net fair value of $49,722,816 for 1934 (II, 798, line 13). Its three witnesses on rate of return stated 7.5% would be proper (I, 360, 369, 372). The Company's actual net earnings for 1933 were $2,527,961 (II, 797, line 20). Hence the Company's evidence of final net return for 1934, solemnly submitted, would result in net return for 1934 of $3,729,211 (7.5% of $49,722,816). This is more than $1,200,000 above actual net return in 1933. Thus the Company's evidence, if accepted, would compel an *increase* of that amount for 1934. The Company has asked the Commission for no increase after 1925, although the Commission was at all times open to such an application.

This shows beyond doubt that the Company's evidence is not sincere on the issue of confiscation. It has ac-

quiesced in, and prospered wonderfully under, its rates in the past, which it now asks this Court to believe were and are confiscatory. Two recent comments of this Court on similar evidence are appropriate. In the *Lindheimer Case*, 292 U. S. 151, 175, the Chief Justice said:

> "The Company has had abundant opportunity to establish its contentions. In seeking to do so, the Company has submitted elaborate estimates and computations, but these have overshot the mark. Proving too much, they fail of the intended effect. It is not the function of the court to attempt to construct out of this voluminous record independent calculations to invalidate the challenged rates. It is enough that the rates have been established by competent authority and that their invalidity has not been satisfactorily proved."

In *Dayton Power and Light Co. vs. Commission*, 292 U. S. 290, decided the same day, Mr. Justice Cardozo said at page 312:

> "The argument proves too much: the valuations are discredited by the teachings of experience. Men do not transact business without protest at confiscatory rates, at all events in the absence of extraordinary circumstances making submission to the loss expedient. If such circumstances exist, the appellant has not proved them. Nothing in the record lays the basis for a belief that the natural gas business in Ohio is unable to pay its way. That being so, what the public utility has done belies what it has said. We shall hardly go astray if we prefer the test of conduct."

II. THE PRACTICAL RESULT OF THE COMMISSION'S ACTION.

The fairness of the Commission's total action is demonstrated by its practical effect on the Company's rates.

We feel bound by recent strong expressions of this Court to present this case in argument primarily from the

standpoint of the practical effect of the Commission's order on the Company's operations. In *Smith vs. Illinois Bell Telephone Co.*, 282 U. S. 133, 160, the Chief Justice said, "In determining what is a confiscatory regulation of rates, it is necessary to consider the actual effect of the rates imposed in the light of the utility's situation, its requirements and opportunities." That approach was also explicit in the *Lindheimer Case*, 292 U. S. 151, 163-4. In *Dayton Power & Light Co. vs. Commission*, 292 U. S. 290, 298, this Court says, "The appellant (the company) may not prevail unless there has been error in the result as well as error in the reasoning." In *West Ohio Gas Co. vs. Commission*, 55 Sup. Ct. Rep. 316, decided January 7, 1935, this Court concentrates on what is there termed "the totality of consequences" of state regulation.

(a) Even on the assumption that the District Court's excessive and independent valuation was correct, the reduction ordered by the Commission was fair and reasonable.

As noted in the statement of facts, the District Court found the probable net revenues of the Company for 1934 to be $2,742,005, and found a fair net return of $2,372,515 (6% of $39,541,921.27). This means that the District Court necessarily found that a reduction in net revenues of $369,490 could be made without confiscation. The Commission ordered a reduction of $1,000,000, which is $630,510 more than the District Court's reduction ($1,000,000 minus $369,490). The District Court's allowance for depreciation expense was $2,000,000, and the Commission's allowance was $1,352,284, a difference of $647,716. The result of these simple computations shows that if the Commission's finding for depreciation expense was a reasonable finding of fact, a reduction of $1,017,206 ($369,490 plus $647,716) was proper *even on the District Court's high valuation*, which was not cost. In other

words, the Commission's total action must be sustained unless the Company has offered the requisite coercive proof that the Commission's finding of fact as to depreciation expense was unreasonably low under the circumstances of this case. This statement, of course, makes the assumption that the District Court's excessive estimate of value was correct, an assumption which cannot be entertained, and which we shall later consider fully. This case, therefore, *can* be decided on the ground of the *Lindheimer Case, supra,* that the Company has asked for an excessive depreciation allowance in an amount sufficient to offset the Commission's reduction. The result indicated above would be the same if the Company's estimate of net income for 1934 were used, as the District Court accepted the Company's estimate except for depreciation, and adjusted the return accordingly.

(b) The net return allowed by the Commission is not only more than a fair return upon fair value, but is also adequate to meet all of the reasonable requirements of the Company over and above operating expenses, for interest, dividends, and other fixed charges, and to provide an additional amount for surplus.

A second specific aspect of the practical approach may be considered in this preliminary discussion: How does the Commission's order affect the Company's present obligations and other requirements over and above operating expenses? As already noted, the Commission estimated a net return of $3,353,793, which was the same as the Company's estimate except for adjustment of depreciation expense and resulting increase of taxes. (For the results in 1934 bearing on this estimate, see Appendix to Commission's brief.) The reduction of $1,000,000 left, therefore, a net return of $2,353,793. How does this

net return of $2,353,793 match up against the Company's present needs?

From Company Exhibit A-2 (I, 599) and testimony of the Company's Auditor, the requirements of the Company as of December 31, 1933, over and above operating expenses, may be expressed as follows:

(1) Advances from affiliated companies:	$2,650,000 at 5.88%	$155,820
(2) Pension fund notes	$1,305,721 at 4%	52,228
(3) Preferred stock	$3,000,000 at 7%	210,000
(4) Common stock	$30,000,000 at 6%	1,800,000
Total		$2,218,048

(For changes in items (1) and (2) as of December 31, 1934, see Appendix to Commission's brief.)

The Commission's allowance of $2,353,793 is therefore ample to cover the Company's fixed charges, to allow a dividend of 6% to its sole common stockholder, the A. T. & T., and to provide a margin for unallocated surplus. As to the right to earn enough to pay dividends, see *Covington Turnpike Co. vs. Sandford*, 164 U. S. 578, 596. While we are aware that this comparison does not automatically dispose of the issue of confiscation, it does show that the Company can get along very comfortably under the Commission's order. The comparison also helps to restore "realities" as against "elaborate calculations". (292 U. S. 164.)

III. DEPRECIATION EXPENSE.

The Court's arbitrary finding of $2,000,000 as the minimum non-confiscatory allowance for annual depreciation expense was excessive and erroneous.

(a) The Commission's allowance for annual depreciation expense was a finding of fact, was based on substantial evidence, and was demonstrably fair and liberal under the conditions indicated by the testimony.

(b) The Court erred in failing to give proper weight to the uncontradicted evidence of the change in economic conditions, which has substantially suspended for an indeterminate period of time in the future the current operation of inadequacy as a factor of currently accruing depreciation, which factor was, under previously existing conditions, the largest single cause of such depreciation.

Because of the importance of the allowance for depreciation expense in this appeal, and because its consideration involves particular discussion of the burden of proof, which is vital to the later argument, we deal with it before taking up value. The Commission allowed to the Company in full all of the operating expenses it claimed except depreciation expense. We approach that subject with the definition given by the Chief Justice in the *Lindheimer Case*, 292 U. S. at page 167:

> "Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence. Annual depreciation is the loss which takes place in a year. In determining reasonable rates for supplying public service, it is proper to include in the operating expenses, that is, in the cost of producing the service,

> an allowance for consumption of capital in order to maintain the integrity of the investment in the service rendered. The amount necessary to be provided annually for this purpose is the subject of estimate and computation. In this instance, the company has used the 'straight line' method of computation, a method approved by the Interstate Commerce Commission. 177 Inters. Com. Rep., pp. 408, 413. By this method the annual depreciation charge is obtained by dividing the estimated service value by the number of years of estimated service life. The method is designed to spread evenly over the service life of the property the loss which is realized when the property is ultimately retired from service."

In a footnote the Chief Justice refers to the Interstate Commerce Commission's definition, given in 177 I. C. C. at page 422:

> "* * * the loss in service value not restored by current maintenance and incurred in connection with the consumption or prospective retirement of property in the course of service from causes against which the carrier is not protected by insurance, *which are known to be in current operation*, and whose effect can be forecast with a reasonable approach to accuracy." (Italics ours.)

The witnesses all accepted the above definitions as accurate, and both Commission and Company used the straight line method familiar to this Court. The Commission heard estimates of witnesses for the People's Counsel and for the Company at great length. It did not accept any of the estimates given, but carefully worked out from the evidence its own findings of separate rates for each class of depreciable property, and applied these rates to the gross value of such classes of property. (See Commission's opinion, I, 57-61). The District Court apparently misunderstood what the Commission had done, as the Court's opinion erroneously

states that the Commission's rates were applied to depreciated value (I, 574). The Commission also expressly followed this Court's ruling in *United Railways vs. West*, 280 U. S. 234, that depreciation expense is to be based on value and not cost. The Commission understands this to mean gross value and not fair value, since the rates are predicated on present service life of new property. The Company's estimates were based on gross cost and alternatively on "reproduction cost new."

Before the Commission the witnesses of People's Counsel stressed, in their approach to their estimates of service lives, that part of the I. C. C.'s definition which limits consideration to those factors of depreciation "which are known to be in current operation." Inadequacy is admittedly the largest single factor in causing retirements and the resulting loss of value in an expanding plant. Equipment adequate to serve a given number of customers is inadequate to serve more than that number, and the equipment must be retired and replaced to meet the increased demand when it exists, even though its physical condition remains unimpaired. The Company's witnesses stated repeatedly that inadequacy was the largest single factor of current depreciation in a growing plant (I, 337, 474, 491).

For years this Company and the others in the Bell System enjoyed a remarkable and steady growth as telephone installations kept pace with other evidences of material prosperity. With the beginning of the present depression, however, the rate of growth first slackened and then changed into a persistent net loss of installations. This trend is shown graphically in the Commission's Exhibits D-18 and D-20 (II, 1088A, 1090A). At the peak of telephones in service, which was not reached until 1931, the Company had in round numbers 221,000; at the end of 1933 it had 199,000. In 1931 the plant was adequate to serve the peak demand. A present slight

upturn is noted, as the Company reports, as of December 31, 1934, 205,000 telephones in service. The witnesses before the District Court were advised of this upturn and made various estimates as to the number of years required to come back to the 1931 peak, assuming the growth continues at the rate operating at the time the case was tried in March, 1934. It was clear, however, that at present, and for an indeterminate number of years in the future, expansion will not force the Company to abandon any of the plant which was adequate to serve the peak of demand. Hence, even on the sanguine assumption that the boom days are slowly coming back, the largest single factor of currently accruing depreciation is not now operating with its prior force in this Company's plant. Therefore, the need for depreciation expense is radically modified, because equipment can now more nearly serve out its normal physical usefulness without having its career prematurely cut off by the juggernaut of material growth. Such a change in conditions necessarily causes a change in the direction of the so-called "straight line," but such a recognition of altered conditions obviously does not affect the method of approach to straight-line estimates when made. (See Mr. Pagon, I, 500-501.) The Company's witness, Mr. Woodford, readily admitted that the straight line could not remain on the same angle throughout changes in conditions; and the Company itself has necessarily from time to time changed the direction of the line whenever it changed its depreciation rates (I, 350), as it has frequently done.

As an illustration of the absence of inadequacy in its present effect on depreciation rates, let us assume that a class of property, in the period when the Company was expanding, had an estimated service life of 20 years, with no salvage, which gives a depreciation rate of 5%. This estimate of service life, when made, necessarily and

properly took account of inadequacy, *i. e.*, retirement from growth, *as the largest single factor*. Later, in 1934, the plant was substantially overadequate to serve present consumers, and will not have to be enlarged to meet increased demands for at least some years to come, if ever. In making a 1934 estimate of service life for that same class of new property, under present conditions, its risk of mortality from inadequacy is not present, and is postponed for an indefinite future period; hence its present probable service life now may be increased, let us assume, to 40 years, to approach its *physical* life, which reduces the annual rate to 2.5%. When and if the former rate of growth ever resumes, overtakes present overadequacy and again forces premature retirements, it would be necessary to revise the estimate of service lives and rates again to meet those conditions. The subscribers, meanwhile, cannot fairly be asked to pay for an element of depreciation which is not presently accruing. The reduction in depreciation resulting from lack of inadequacy may be compared to the reduction which would result in life insurance premiums if the largest single factor causing death were removed, so that average human life became longer.

No one can possibly predict when, if ever, economic conditions will again enable the Company to grow so fast that it will be forced to tear out equipment to meet demands for added service. It would be interesting to speculate whether as late as 1931 the peak installations of this Company did not closely approximate the saturation point within any given area. The telephone is a necessity in American life today, and was in 1931. It is difficult to imagine a growth in population, combined with a return to the boom days, which would force retirements from inadequacy at the rate which, in prior years, gave the United States the highest telephone concentration in

the world by several hundred per cent.—an achievement in which the A. T. & T. may and does justly take pride.

We elaborate this very plain fact that the need for depreciation expense is less, merely because the Company has argued heretofore that the Commission's witnesses departed from the straight line method when they estimated longer service lives for some classes of plant due to the substantial moratorium of current inadequacy. The only material difference between witnesses for the Commission and the Company on this point was in their judgment as to the degree of effect of the present diminution of inadequacy. All agreed that it was a new phenomenon in depreciation estimates. The testimony on depreciation expense of Messrs. Pagon and Holland, for the Commission, which discusses these matters fully, is concisely set forth in the record at I, 474-488, and I, 490-514, respectively. Mr. Woodford's testimony for the Company is also brief and appears at I, 339-353. Mr. Gompf, for the Company, presented elaborate and detailed studies which are described in I, 310-339.

As pointed out by the Chief Justice in the *Lindheimer Case*, 292 U. S. at pages 169-170, estimates of this kind are at bottom judgment figures, and are not susceptible of mathematically accurate determination. Assumptions must be first arrived at, and judgment enters into the final result at several intermediate stages (I, 498). The Commission's witnesses and the Commission were familiar with the Company's studies and methods; these they approved in their mechanical aspect, but they disagreed with the Company on some of the judgment factors.

Mr. Woodford, who had not testified before the Commission, professed to be shocked because he noted that the Commission in its opinion had checked the engineers' evidence of future depreciation requirements against the Company's retirement experience. He deplored the Commission's unorthodoxy in reverting to what he pur-

ported to believe was "retirement accounting." No one can read the Commission's opinion and believe that retirement accounting was followed (I, 57-61). Mr. Woodford's gratuitous red herring was, moreover, promulgated only a few weeks before this Court said in the *Lindheimer Case*, 292 U. S. at 170: "The necessity of checking results is not questioned. The predictions must meet the controlling test of experience." In the same case Mr. Justice Butler's concurring opinion goes far to suggest that even the straight line method itself is no sacred test of depreciation expense in confiscation cases. This Commission has for many years used the straight line method and did so in this case. It believes that its use is fair to both utilities and consumers when reasonably applied; it believes, too, that depreciation expense so computed provides automatically a continuing margin of safety above confiscatory rates, as distinguished from fair and reasonable rates. *Banton vs. Belt Line Ry. Co.*, 268 U. S. 413, 423. The accounting methods of the A. T. & T. are not written into the 14th Amendment, although the Commission has been willing to adopt them in the exercise of its statutory duty to insure fair and reasonable rates.

We may note also that when this case was tried in March 1934, this Court had not yet reversed the Illinois District Court by the decision in the *Lindheimer Case*, delivered some weeks later. The ground of this Court's decision was primarily that the depreciation rates of the Illinois Bell Telephone Company in Chicago were too high (292 U. S. 175). Thus the following testimony of Mr. Woodford in our case, given *before* this Court's opinion was announced, is, to say the least, significant (I, 348):

> "This exhibit has greater significance than to indicate that all of the Bell Companies use the same methods. It also shows that there is not a wide dis-

crepancy between the actual depreciation rates used by the Chesapeake and Potomac Company and those used by other companies. *The Illinois Bell Company in Chicago has exactly the same ratio as the Chesapeake and Potomac Company of Baltimore City.*" (See II, 793.)

Before the District Court the Company claimed for annual depreciation expense for 1934, $2,173,000 (II, 797). The Commission had allowed $1,352,284, arrived at as previously described. *The Commission's witnesses had both estimated substantially lower amounts.* In 1933 the Company was, as indicated, no longer growing, and its retirements from inadequacy consequently fell off very sharply. During 1933 its depreciation reserve increased by $1,253,377, or from 20.46% to 22.96% of fixed capital (I, 599, line 42). Thus, if the Commission's allowance for depreciation, which the Company claims is confiscatory, had been in effect during 1933, the Company's reserve would still have increased by at least $439,450, and the percentage of reserve would have increased from 20.46% to 21.33%, while the plant increased only $33,332. It is significant to note that the Company was able to reduce its debt to "system corporations" by $1,025,000 during 1933 (I, 599, line 36).

As the 1934 results of the Company's operations are not part of the record, they have not been argued in this brief, but are indicated and briefly discussed in the Appendix to the brief. They are taken from information furnished by the Company to the Commission, and their accuracy cannot be questioned. Counsel in providing these figures are mindful of this Court's frequent statements that results are better than prophecies (e. g., *Galveston Electric Co. vs. Galveston*, 258 U. S. 388, 402); especially in a case where the Company has challenged the rates without allowing a test period. Of

course the complete 1934 results were not available when this case was tried before the District Court in March 1934. These figures are of particular importance in relation to depreciation expense, because the District Court, in rejecting the Commission's allowance, stated that its demonstrable sufficiency in one year's experience might not be conclusive (I, 577).

This Commission believes in adequate depreciation rates and an adequate depreciation reserve, as its record with this Company has demonstrated. Thus, after the 1916 Commission case, as of 1914 (II, 958-969), very high depreciation rates were allowed the Company because the Commission believed a reserve of approximately 20% should be built up and maintained. In 1914 it was only 14.77% (II, 875). The present reserve has not been considered in reaching depreciation rates. The Commission used the straight line method, and was well aware of and discussed this Court's ruling in *Commissioners vs. N. Y. Telephone Co.* (*the New Jersey Telephone Case*), 271 U. S. 23, which forbids taking an excessive reserve to reduce future rates (I, 50). While the Commission was not influenced by the reserve being above the normal 20%, we submit that such an excess may be a factor to be considered on review in determining whether a given depreciation allowance is unreasonably low. We do not press this point, because the Commission did not consider it, but it appears to be implicit in this Court's decision in *Columbus Gas and Fuel Co. vs. Commission*, 292 U. S. 398, where it is said at page 414:

> "The Commission determined that *in view of the large reserve* and the good condition of the plant, the allowance asked for by the company ($174,880.24) was too high, and that $68,196 was adequate." (Italics ours.)

See also *Clark's Ferry Bridge Case*, 291 U. S. 227, 239.

To throw further light on the Commission's liberal policy in regard to upkeep of this Company's plant, we give below a table comparable to one of those set forth in the Chief Justice's opinion in the *Lindheimer Case, supra*, in connection with which he discusses the practical necessity of considering maintenance and depreciation expense together as complementary factors with the one function of preserving the integrity of the plant (292 U. S. 173-174). In column (1) are the years; in (2) maintenance claimed and allowed; in (3) depreciation claimed and allowed; in (4) total of (2) and (3); in (5) total operating expenses; and in (6) the percentage of (4) to (5). The figures are taken from Company's Exhibits A-5, I, 611; and A-6, I, 613.

(1)	(2)	(3)	(4)	(5)	(6)
Year	Maintenance	Depreciation	Maintenance plus Depreciation	Total Expenses	Percentage
1924	$1,580,135	$1,448,417	$3,028,542	$ 8,188,808	36.98%
1925	1,689,350	1,635,506	3,324,756	9,000,226	36.94%
1926	1,744,665	1,800,036	3,544,701	9,305,850	38.09%
1927	1,876,735	1,967,815	3,844,550	10,039,367	38.29%
1928	1,990,943	2,103,512	4,094,455	10,134,028	40.40%
1929	2,109,699	2,231,797	4,341,496	10,761,139	40.34%
1930	2,229,807	2,335,715	4,565,522	11,198,224	40.77%
1931	2,107,329	2,432,249	4,539,578	11,039,850	41.12%
1932	1,922,344	2,541,773	4,464,017	10,522,936	42.42%
1933	2,072,210	2,166,211	4,238,421	9,898,857	42.82%

It will be observed that the total of allowances for maintenance and depreciation are in even higher, though more uniform, percentages of total operating expenses than claimed by the Illinois Bell Company (see 292 U. S. 174). The table illustrates how generous the Commission's policy is in such matters, and also brings into relief the Company's contention that it has suffered (in silence) from confiscation since 1924.

Not to burden argument with undue statistical details, only one other table will be given, showing (1) the years, (2) depreciation expense, (3) charges to depreciation reserve (*i. e.*, amount of expense used), and (4) resulting changes in reserve (I, 609, lines 2 and 10):

(1) Year	(2) Depreciation Expense	(3) Charges to Reserve	(4) Changes in Reserve
1924	$1,448,417	$1,521,086	($ 72,669)
1925	1,635,505	1,508,324	127,181
1926	1,800,036	1,358,713	441,323
1927	1,967,815	1,274,824	692,991
1928	2,103,512	1,548,197	555,315
1929	2,231,797	1,521,507	710,290
1930	2,335,715	2,268,389	67,326
1931	2,432,249	2,301,156	131,093
1932	2,541,773	2,294,292	247,481
1933	2,201,853	1,031,182	1,170,671

The figures do not reflect the total actually added to reserve, as additional amounts were available from other accounts. Thus the actual increase in reserve in 1933 was over $1,250,000, though column (4) does not reflect this full amount. This table is, therefore, favorable to the Company. (These tables are completed for 1934 in Appendix to Commission's brief).

A comfortable addition to reserve was possible in every year except 1924. In contrasting the past years with 1934 it should be recalled that until 1933 substantial net increases in plant were being made, so that the increases in reserve varied little in percentage of total plant. In 1933, however, only $33,332 was added to plant, while the reserve increased by over $1,250,000.

It should be also clearly noted that the large retirements in 1930, 1931 and 1932, in spite of the depression, were occasioned by unusually severe sleet storms, and by the Company's wholesale changes to dial instruments

and French hand sets (I, 389). These latter replacements were not essential, but served to keep down the increase in reserve until 1933. The District Court overlooks the unnecessary and subjective character of these substitutions (I, 577). For the purpose of argument, we assume that these changes in equipment were an advantage to subscribers. That such changes could be made without dipping into reserve is eloquent evidence of the comfortable margin supplied by depreciation expense allowances. (See 292 U. S. 175.)

(c) The rate and amount found by the Court were arbitrary round figures, based on no specific evidence as applied to separate items of depreciable property.

It was in pursuance of such established liberality in allowing the Company's expenses that the Commission approached depreciation expense for 1934. It followed the same policy, made a careful computation from all the evidence, and made an allowance demonstrably generous. The District Court brushed aside the Commission's finding of fact, substituted its own judgment on this item (as on others), and produced the arbitrary round figure of $2,000,000 for depreciation expense in 1934. The Court found no separate rates for various classes of depreciable property, and frankly relied on no coercive evidence from the Company to justify setting aside the Commission's finding of fact, reached after mature and experienced deliberation.

(d) The Court erred in substituting its judgment for the judgment of the Commission, because the proof of the Company was lacking in the force legally required to establish that the Commission's finding was clearly wrong.

We submit most earnestly that the District Court throughout its opinion shows that it misconstrued the

burden of proof in such cases, and the resulting scope of its power to substitute itself as the rate-making body. The argument here made on the burden of proof in connection with the important item of depreciation expense applies equally to other items throughout the District Court's opinion. It is deemed essential to make the argument here, because the District Court's opinion on depreciation expense discloses expressly the nature of the evidence it relied on and the uncertainty of the Court itself in reaching its conclusion.

The District Court in explaining its attitude says simply: "On the issue of confiscation the Court must exercise its own independent judgment of law and fact." (I, 562). It cites the familiar case of *Ohio Valley Water Co. vs. Ben Avon*, 253 U. S. 287. That case held, by a divided Court, that the Pennsylvania statute there involved did not provide a fair review in confiscation cases in that it bound the courts to the facts as found by the commission. The principle announced had been long recognized in earlier cases, *e. g., Chicago, Milwaukee Ry. vs. Minn.*, 134 U. S. 418; and the question on which this Court divided was only the application of the principle to the specific statute involved. The case did not involve the burden of proof, nor did it affect in any degree the clear statements of this Court in prior and later cases on the function of reviewing courts in such a case as this. The *Ben Avon Case* reaffirms the inherent right of the judicial branch to exercise its own judgment on constitutional questions, but it does not alter the question which is the *object* of the Court's independent judgment. It is the clear law of this Court, repeatedly announced in cases before and after the *Ben Avon Case*, that the Courts must apply their independent judgment in answer to this question: Has the plaintiff proved that the legislative body's total action necessarily produces confiscation, by evidence so clear and convincing that it

"excludes every choice but one", or "beyond all doubt"; or which "applies coercion to the minds of the appointed triers of the facts"? In the absence of such proof, the court, in recognition of the fundamental division of governmental powers, cannot retry the case as a jury and fix new rates by substituting its judgment on subsidiary facts, based on conclusions which the court *might* have reached from the same evidence. As we are aware that the *Ben Avon Case* has been drafted for strange duty in utility briefs in other cases, and since the District Court in this case appears to have misunderstood its application, we will consider the law in some detail.

In *San Diego Land & Town Co. vs. National City*, 174 U. S. 739, a utility claiming confiscation had sought to enjoin rates fixed by ordinance of a municipal body. This Court discussed *Chicago, Milwaukee Ry. vs. Minn, supra*, and quoted with approval from that case the following language construing a state statute—expressing 30 years in advance the *ratio decidendi* of the *Ben Avon Case*:

> "It (the statute) deprives the company of its right to a judicial investigation by due process of law, under the forms and with the machinery provided by the wisdom of successive ages for the investigation, judicially, of the truth of a matter in controversy, and substitutes therefor, as an absolute finality, the action of a railroad commission, which, in view of the powers conceded to it by the state court, cannot be regarded as clothed with judicial functions or possessing the machinery of a court of justice."

Approving this view, this Court goes on, at 174 U. S. 754, to state the issue to which the "judicial investigation" must be directed:

> "But it should also be remembered that the judiciary ought not to interfere with the collection of rates established under legislative sanction, unless

> they are so plainly and palpably unreasonable as to make their enforcement equivalent to the taking of property for public use without such compensation, as, under all the circumstances, is just, both to the owner and to the public; that is, judicial interference should never occur, unless the case presents, *clearly and beyond all doubt*, such a flagrant attack upon the rights of property, under the guise of regulations as to *compel* the Court to say that the rates prescribed will necessarily have the effect to deny just compensation for private property taken for the public use." (Italics ours.)

A few years later, in *San Diego Land & Town Co. vs. Jasper*, 189 U. S. 439, after quoting with approval from the earlier case of similar name, Mr. Justice Holmes' said at pages 441-442:

> "In a case like this we do not feel bound to re-examine and weigh all the evidence, although we have done so, or to proceed according to our independent opinion as to what were proper rates. *It is enough if we cannot say that it was impossible for a fair-minded board to come to the result which was reached.*" (Italics ours.)

In *Georgia Ry. and Power Co. vs. Commission*, 262 U. S. 625, decided three years after the *Ben Avon Case*, Mr. Justice Brandeis notes at page 630, "The lower court recognized that it must exercise an independent judgment in passing upon the evidence"—(not in finding new rates); and later he says at page 634, citing the two *San Diego Cases*, "We cannot say that the evidence compelled a conviction that the rate would prove inadequate." These two brief quotations put the *Ben Avon* doctrine where it belongs, as a rule of judicial review, and not one of judicial rate-making. The *Georgia Railway Case* also definitely determined that the proper allowance for depreciation expense is a question of fact: "This question

is one of fact, and we are not convinced that it was wrongly decided below." (*Supra*, 633.)

In *Los Angeles Gas & Electric Co. vs. Commission*, 289 U. S. 287, at 304, the Chief Justice cites the second *San Diego Case* with approval in connection with the burden of proof, and says, "We do not sit as a board of revision, but to enforce constitutional rights"; and later at page 305:

> "That question is whether the rates as fixed are confiscatory. And upon that question the complainant has the burden of proof and the Court may not interfere with the exercise of the State's authority unless confiscation is clearly established."

In the *Clark's Ferry Bridge Case*, 291 U. S. 227, in which the company and the commission differed widely in their estimates of depreciation expense, finding 2½% and 1% respectively, the Chief Justice said at page 240:

> "In reviewing the findings of the state court we are not required to enter a debatable field of fact and to choose and prescribe an invariable method of computation. To justify the overruling of the determination of the state court we must be able to see that what has been done will produce the result which the Constitution forbids."

In *Columbus Gas & Fuel Co. vs. Commission*, *supra*, the company had asked for depreciation expense in the amount of $174,880; the commission had allowed only $68,196. Of the commission's allowance this Court said at 292 U. S. 414: "This is slightly less, it is true, than the amount ($88,695.03) suggested by a witness for the city, *but the Commission was at liberty to form its own judgment.*" (Italics ours.)

In *Dayton Power & Light Co. vs. Commission*, *supra*, the heavy burden of proof upon a plaintiff seeking to set aside a commission's findings is vigorously stated. Speak-

ing of evidence urged by the company as proof of the commission's error, Mr. Justice Cardozo says at 292 U. S. 301: "It had no such commanding quality as to apply coercion to the judgment of the appointed triers of the facts, and exclude every choice but one." Again he says, "Plainly in all this there has been no infringement of constitutional immunities unless a higher value has been made out by evidence too strong to be rejected." This Court says also at page 309, "For the legislative process, at least equally with the judicial, there is an indeterminate penumbra within which choice is uncontrolled." The Chief Justice (then Mr. Justice Hughes) had emphasized the same fundamental distinction twenty-one years earlier in the *Minnesota Rate Cases*, 230 U. S. 352, 433, when he said that the power of making rates necessarily implies a range of legislative discretion. See also his statement in the *Los Angeles Case*, 289 U. S. at 314.

Mr. Justice Butler, in *Aetna Ins. Co. vs. Hyde*, 275 U. S. 440, citing the *San Diego Case* in 189 U. S., says at 447: "Jurisdiction of this Court to set aside state-made rates as confiscatory will be exercised only in clear cases."

The question of judicial review in such cases is ably considered by Mr. John Dickinson in "Administrative Justice and the Supremacy of Law" (Harvard University Press, 1927), Chapter VI. Discussing the *Ben Avon Case* in its application to review of rate determinations he says, at page 198:

> "It seems altogether plain, as the majority opinion says, that he is entitled to the 'independent judgment of the court' upon the question of whether on both the law and the facts the order or statute complained of is or is not constitutional; but that does not mean that he is entitled to the 'independent judgment' of the court on the subsidiary questions which have a bearing on the question of constitutionality. If this were so, a court would be bound to declare every piece of legislation and every adminis-

trative order unconstitutional where it would not itself under the same circumstances or on the same evidence have reached the same conclusion as the legislative or administrative body. In other words, every doubt would have to be resolved against the constitutionality of the statute or order. But the rule is exactly contrary. The person asserting a constitutional right is entitled to the 'independent judgment of the court' on the ultimate question of constitutionality; but in exercising that judgment the court is bound to give effect to a presumption in favor of the validity of the statute or order, and this can mean only that if there is any construction of the subsidiary facts within the bounds of reason which would make the statute or order constitutional, that construction must be adopted, rather than the construction which the court would 'independently' place upon the same facts."

Quoting the opinion of Mr. Justice Sutherland in *Radice vs. New York*, 264 U. S. 292, 294, Mr. Dickinson continues:

"The Supreme Court itself has said since the Ben Avon case that 'where the constitutional validity of a statute depends upon the existence of facts, the courts must be cautious about reaching a conclusion respecting them contrary to that reached by the legislature; and if the question of what the facts establish be a fairly debatable one, it is not permissible for the judge to set up his opinion in respect to it against the opinion of the law maker.' Surely the formal conclusions of facts reached by an administrative tribunal after a hearing and the taking of testimony should be entitled to as much respect as findings of fact supposed to have been made by a legislative body as the implied basis for its enactments. Indeed, judicial review of the rate-fixing orders of utilities commissions proceeds on the theory that such orders are 'legislative' in character. If so, they should have the benefit of the language of the Court just quoted as to legislative findings of fact."

Further laboring of the point is not necessary to show that the *Ben Avon Case* and others addressed to the function of judicial review do not conceivably justify a court in fixing its own rates, much less depreciation expense, unless the plaintiff has presented evidence of confiscation too strong to be rejected. To avoid repetitious quotation, the following additional cases are cited:

Knoxville vs. Knoxville Water Co., 212 U. S. 1, 8, 16;
Louisville & Nashville R. R. Co. vs. Garrett, 231 U. S. 298, 313;
Van Dyke vs. Geary, 244 U. S. 39, 48;
Darnell vs. Edwards, 244 U. S. 564, 569;
New York, etc., Gas Co. vs. McCall, 245 U. S. 345, 347.

This discussion of the division of powers and the corollary emergent law on the burden of proof, especially where confiscation is charged, applies to the District Court's whole approach to this case, but it has peculiar significance as related to Judge Chesnut's treatment of depreciation expense in his opinion for the District Court, because he discusses and weighs the evidence. To throw into relief the District Court's *rationale* of its function on review, we ask this Court to consider the following extracts from the opinion, against the background of the principles considered above. Discussing the evidence on depreciation expense the District Court says (I, 574-578):

"Both are only estimates for the future based on opinion evidence of experts. * * * it is conceded by both sides that an important change has recently taken place * * * this factor (of inadequacy) ceased to be operative with its prior force in 1932 and 1933 when the growth of the Telephone Company temporarily ceased. * * *. It thus appears that the Company took out of its revenues and charged to depre-

> ciation expense at least $1,250,000 in 1933, more than was necessary to preserve the level balance of 20% which, over a long period of years, had been determined by the Commission and found by experience to be a sufficient depreciation reserve for this Company. These figures are significant, and reasonably lead to the inference that the change in conditions owing to the halt in progress of the Company was of material importance. * * * Even the Company's estimates of renewed growth do not indicate a return to conditions approximating those of 1931 for at least two or three years in the future. * * * As the proper depreciation allowance for the near future is, under the conditions now existing, necessarily an estimate only, it is obviously not susceptible of mathematical demonstration, but should be the result of a reasonable judgment on consideration of all relevant facts."

Having thus weighed the evidence, and expressly noting the doubts, prophecies and uncertainties inherent in such computations, one would, we respectfully submit, confidently expect to have the District Court conclude that in this state of the evidence the Commission's judgment, *which it "was at liberty to form"*, must be sustained. Instead, the Court continues: "In *our* opinion the depreciation allowance at the percentage rate of 4% on the book cost of the plant now in service is reasonable and proper for the ensuing year." (Italics ours.)

Plainly, admittedly, the District Court did not feel that the Company's evidence compelled conviction, excluded every choice but one, was clear beyond all doubt, or that it was impossible for a fair-minded body to reach the Commission's conclusion, etc. On the other hand, the District Court confessedly substituted its judgment on a debatable question of fact, and to make the error more palpable, did so without even making findings of applicable depreciation rates on separate classes of depreciable property. If the action of a conscientious and

demonstrably conservative Commission is to be nullified *on such terms*, we submit with all good nature that the Commission has no place in the scheme of government.

IV. THE COMMISSION'S VALUATION.

The Commission in finding fair value gave effect both to cost when incurred and to present value, and considered every other element of value required by law, and the value so found was fair and reasonable and supported by substantial evidence. The method of valuation used by the Commission was substantially that used by the District Court itself in the previous case involving the same parties in 1925.

(a) The Commission's valuation of the physical plant accepted actual investment at cost when incurred and referred such dollars of investment to current value.

For the purpose of this case "value" must be considered from the standpoint of its practical function in rate regulation. We must likewise accept the basic assumption that, while value and rate of return are supplementary instruments to measure dollars of net return, they must be determined separately. Value signifies, in rate regulation, the investment in *dollars* on which a utility is entitled to earn, which must be representative of the sum previously and prudently dedicated to the enterprise in terms of present economic conditions. The dollars when so invested were free units of exchange value, having an earning significance then and now only because they are such units of exchange. When invested originally, they represented on the one hand so many poles and miles of wire and other units of telephone equipment; on the other hand the same dollar units then represented certain quantities of government

bonds, wheat fields, apartment houses, automobiles, fur coats, gold bullion, beefsteaks, services of all kinds, etc., etc. By definition, the dollars invested by the A. T. & T. in the Maryland Telephone Company, had *no* value unless they *were* interchangeable for other requirements and desires of the stockholders of the A. T. & T., and the corresponding requirements and desires of *all* persons who use the dollar as a measure of value. Thus a regulating body in finding fair value must find a number of universal units of purchasing power and earning power; that is, exchangeable dollars invested, in terms of present exchangeable dollars.

This appears clearly implicit in this Court's treatment of utility earnings. The measure of value is repeatedly expressed in general terms applicable to all common forms of investment. Utility values are geared into and move broadly with other forms of earning value. Thus this Court in utility valuation cases has repeatedly taken judicial notice of changes in *general* price levels, has spoken of "business conditions generally", "the consumption of commodities", has noticed the present depression as "a different economic era", etc. See the following:

Southwestern Bell Telephone Co. vs. P. S. C., 262 U. S. 276 at 287-288;

Bluefield Water Works vs. P. S. C., 262 U. S. 679 at 689-692;

McCardle vs. Indianapolis Water Co., 272 U. S. 400 at 408-410;

Atchison, Topeka & Santa Fe Ry. vs. I. C. C., 284 U. S. 248 at 260-262;

Los Angeles Gas & Electric Co. vs. R. R. Com., 289 U. S. 287 at 308, 309;

Central Kentucky Natural Gas Co. vs. R. R. Com., 290 U. S. 264 at 274, 275.

The statements in these cases were all made with direct reference to their bearing on utility values. There is no suggestion in them that the A. T. & T. has a preferential constitutional right not to learn how the rest of the world lives, any more than the other utilities involved in the cases cited.

The investment in a utility is dedicated to use by the public, and is entitled to a return from the same public. The public's circumstances, that is, general economic conditions, must be taken into account, for regulation has no significance except as a function of public welfare and convenience. The constitutional corollary, that regulation shall not result in confiscation, merely means that the utility shall not be deprived of something to which the general investor is entitled, both in present value of the money invested and in rate of return thereon. *The very term "reasonable" necessarily premises a criterion originating in general experience.* This fundamental conception is qualified by a policy of regulation that utility valuations shall not swing to speculative heights on the one hand, nor to distress prices on the other. Valuations should therefore respond only to relatively stable levels, such as the low level the United States has endured since 1929.

In approaching an actual valuation in the light of these necessary considerations, a regulatory body must have a concrete starting point. An accepted valuation as of a previous date, if available, is practically mandatory as a start.

It is respectfully suggested that the District Court completely misunderstood the Commission's position in taking the same Court's 1923 valuation as its starting point (I, 568). It is not contended that the District Court was not free to depart in 1934, as it did, from its *method* of 1925, nor is it contended that the value as of 1923 is *res adjudicata* in the sense that the value is the same

now as it was then. (Compare *Clark's Ferry Bridge Case*, 291 U. S. 227, 233). The Commission merely says, as a practical matter, that the 1923 value as established by the District Court in 1925, was favorable to the Company, and has been acquiesced in by Company and Commission from 1925 to 1933, though the Commission was open to hear requests for increased rates during that whole period. See *Galveston Electric Co. vs. Galveston*, 258 U. S. 388, 402. The Commission, to say the least, could not with propriety assume in advance that the District Court would in 1934 question its own 1925 findings. See *Los Angeles Case*, 289 U. S. 287, 308.

The practical bearing of the technical point is not material, however, as the Commission's Chief Auditor, Mr. Smith, tested the application of the index numbers by going behind the 1923 valuation to the Commission's accepted 1914 value and bringing that up to 1933, and the result was substantially the same (I, 400-1). The Company's witness Dr. King also stated the rather obvious fact that if the 1923 value was reached by applying index numbers starting in 1914, the result in 1933 would be necessarily the same whether one started in 1914 or merely carried the process on from the 1923 value (I, 309).

For changes occurring since such a previous valuation, accurate annual cost figures of money actually required and prudently spent at the time, are the acceptable intermediate material. In this case the District Court's valuation as of 1923 furnishes the first step, and the Company's actual cost of net annual additions carries the process down to date. The total of these items shows, as of 1933, what amounts of money in 1923, and what separate amounts in each succeeding year were dedicated to the public service under the various conditions prevailing at those various times. If those price conditions were all the same as in 1933, or even roughly the same,

no adjustment in the total would be indicated, and the Commission could have found a fair value on that total, as was properly done under those conditions in the *Los Angeles Case*, and the *Clark's Ferry Bridge Case*.

In this case it would have required no specific evidence to recognize, in the words of the Chief Justice, that since 1929, "The country was facing a most serious decline in prices. It was entering upon a period of such depression as to constitute 'a new experience to the present generation.' It was not the usual case of possible fluctuating conditions but of a changed economic level." (289 U. S. at 311-312). But specific and accurate measures of the change in levels were before the Commission and the District Court in our case.

The Commission thus had before it, as the raw materials of physical valuation, what may be called x 1923 dollars from the District Court's 1925 valuation, and it had also y 1924 dollars, z 1925 dollars, etc., for each intervening year's net plant additions at cost. It had also specific, uncontradicted evidence that up to 90% of the 1932 plant had been installed during the previous higher levels (I, 21, 391-393). It had also the Company's evidence of total historical cost (I, 16, 601) and the Company's elaborate combination of appraisal, inventory and index numbers, which was referred to as reproduction cost (I, 18; II, 736). The Commission was satisfied that in the low level of this depression, present fair value could not be as high as historical cost incurred at higher prices, if the explicit and repeated statements of this Court on that subject were accepted (I, 21-23). The Commission, furthermore, could not accept Western Electric prices which *went up* in 1930 and stayed up, as a fair criterion of present value for public rates. The Company's so-called reproduction cost evidence of value was slightly higher than historical cost, and was colored with such conjectural, unrealistic, even fantastic conceptions

of overheads and intangibles that in addition to falling of its own weight, it necessarily further vitiated the historical cost also, since the two were practically the same. These evidences of the Company will be discussed in great detail later; suffice it to say here that, although it considered them fully, the Commission could not accept them as fair value for 1934. The Commission was, therefore, faced with the job of selecting, out of the evidence before it, a fair criterion of value on which the Company should earn in 1934 and for the near future. It had the raw material of the algebraic total of dollars invested at price levels varying by degrees from current levels. That total was aptly described by Dr. King, a witness for the Company and an economist from New York University, when he said: "$1,000 invested in 1913, $1,000 in 1920, $1,000 in 1921 and $1,000 in 1932, or $4,000 invested altogether, gives a total which is much like a total of apples and pears and potatoes and somewhat difficult to utilize." (I, 308.)

As previously stated, the Commission also had in evidence before it 15 recognized indices of commodity and construction price trends, labor rates, business conditions, etc., (see I, 32, 37). It also had the opinion of the District Court in 1925 that a general index, *offered by the Company*, was a proper method of translating previous price levels into values of the present price level to accord with the change in purchasing power of the dollar. The Commission felt, in the first place, that if the All Commodities Index had been offered by the Company and had been used by the District Court to reach a value in which the Company had acquiesced for 9 years, the same principle, more accurately developed, could not now be unfair to the Company simply because prices had come down.

More important, however, the Commission was convinced, independently of the precedent, that the trend-

ing of value by the use of accepted index numbers, under the conditions, was the most reliable guide to present value. See the very interesting discussion of price changes in U. S. history by Mr. Smith (I, 393) and the chart at II, 840A. In 1929 the District Court had no evidence to make allowances for the proper weightings of labor and materials; it had no data for building construction prices, nor did it have before it the I. C. C. index for railroad telephone construction, and many others described and analyzed in great detail by Mr. Smith (I, 397-426). All of these additional factors were offered in evidence and fully considered by the Commission, and a carefully weighted index developed, which it believes is more accurate than the District Court's use in 1925 of the All Commodities Index by itself, although the difference in results is not great; the Commission's weighted index gives the higher value (II, 843).

The index numbers before the Commission represented both general and special purpose index numbers. The general index numbers reflected the prices of commodities, both in the aggregate and by classes, and the cost of living. The special purpose indices reflected building construction costs, electric utility construction costs, and telephone construction costs. All of the index numbers except the Western Electric showed heavy declines beginning in 1930; and the special purpose index numbers declined substantially in accord with the general commodities and cost of living indices. The significant fact is that there was substantial agreement among them all, with the exception of a few specially designed to be sensitive, or which were narrow in their range, and these latter showed values much lower than found by the Commission. Thus the Commission's value as of December 31, 1932, without working capital, was $31,960,000 (I, 76), which conforms closely to the average of individual values disclosed by the special purpose indices.

Two of the special purpose indices used by the Commission are worthy of individual consideration. One is the Western Electric index number, which was filed by the Company before the Commission. That index, ignoring the arbitrary advance in prices made in November, 1930, indicates a value of $34,567,633, without working capital (II, 869). A decrease of only 10% in prices subsequent to 1929 would disclose a value somewhat less than was found by the Commission. The second special index is that of the Interstate Commerce Commission, prepared for telephone and telegraph properties of railroads, which disclosed a value of $32,024,462, without working capital (II, 867). The latter two, being special purpose index numbers in every sense, inasmuch as they were compiled from the prices of telephone properties exclusively, show by themselves, without the additional support of the others, that a fair-minded Commission could not have done otherwise than find a value of some $32,600,000, as was found by the Commission. (See the very full description, analysis and application of the indices used by the Commission in the testimony of Mr. Smith, I, 397 and following).

There was much evidence to prove that prices and values in general followed the All Commodities Index. Thus the witnesses who appraised the buildings for the Company as of 1923 and as of 1932 would have reached almost the identical value in 1932 if they had used the All Commodities Index to obtain the latter figures (II, 845). Also, the materials which largely went into telephone company construction decreased from 100 in 1926 to 44.66 in April of 1933, whereas the All Commodities Index decreased from 100 to 60.4 during the same period (II, 847). Again, the highway construction costs descended more rapidly than the All Commodities Index (II, 848A). The All Commodities Index disclosed a value of $30,458,179 as of December 31, 1932, and the Building

Materials Index of the United States Department of Labor indicated a value of $33,140,625, both without working capital. A very interesting test, applying specific indices to specific elements of the Company's property, closely confirms the Commission's value (II, 870).

The Company claims in effect that no index conforms to its experience because no index, whether general or special, and regardless of how special, remains high enough to give it the value which it seeks. The Company's index of its construction cost therefore is higher than the highest. It stands alone. It strains credulity to the breaking point to believe that there is any factor "special" enough to explain why, when all types of building , all types of commodities, all types of labor, all types of special and general property, are plunging down, this Telephone System alone should in this "changed economic level" stand by itself on the heights of 1929 as a measure of fair value.

Through the final index developed by the Commission from the factors just described, the 1923 value found by the District Court was first trended to 1933 value, and each year's net additions, at cost, were similarly and separately trended. The resulting dollars of plant value gave, in terms of 1933 dollars, the total of dollars invested in the previous years at levels then prevailing. This determination included going value, but not working capital.

No method of valuation can be precise, and the Commission does not assert that the method it followed is perfect, or that it is preferable to reasonable cost if price levels have not materially changed, but it does know that the method is far more trustworthy than engineers' appraisals, which often differ by 50% in the same case (I, 384; II, 830), and that the method is practicable, expeditious, and inexpensive. The Commission also believes, that on the evidence before it, no other valuation could have been accepted.

More significant than these practical considerations, however, it is earnestly submitted that this carefully weighted index valuation resolves the stubborn theoretical *impasse* between prudent investment and the accepted doctrine of present fair value. The index valuation *recognizes and gives full effect to cost when incurred, under conditions then prevailing.* Using that cost as a basis, it indicates the present earning value of that cost, that is, present fair value.

Before the District Court in this case, the Company offered two witnesses who had not testified before the Commission, for the express purpose of criticizing the use of general indices to value what they persisted in calling the "specialized" property of the Company. (As to the enormous variety of property going into the plant, see II, 846, 848B.) It was easy enough for these witnesses to show that isolated commodities (which have no relation to this plant) fluctuate with complete disregard for general levels. The graph introduced through the Company's witness, Dr. King (II, 768A), illustrates these admitted eccentricities. It may be noted in justice to Dr. King that he did not prepare the graph or select the commodities used in it (I, 298). This irrelevant demonstration has a ready plausibility, and might even be convincing if it were directed to the real issue of *rate* valuation, or if the telephone plant were actually "specialized." Such evidence does not reflect the true purport of Dr. King's testimony. The significance of his interesting testimony on the theory of valuation was developed on cross-examination (I, 298-310). While denying, perforce, that the Commission had used the proper index, he openly approved the modification of cost or prudent investment in utility valuation by the use of an index to measure the change in the purchasing power of the dollar, though he was not prepared to commit himself to any specific index for the purpose. He says (I, 307-8):

"My own feeling would be that it would be more logical to value the property of the monopoly on the basis of a prudent investment, provided the changes in the price levels were allowed for. I understand that that theory has never been adopted, because of the fact that people have been loath to admit that the price level has changed, and that reproduction cost theory has therefore been evolved as a rough way of taking account of these changes in price levels. My personal view is that we should adhere to the prudent investment theory, modified with reference to the changes in price levels.

"To determine the change in price levels in my theory, it would be necessary to find out what the dollar would buy in terms of the investment at different times, so that the dollars of one year could be added to the dollars of another year; * * *".

Thus, when Dr. King addresses himself to the real issue as to value *for the purpose of this case*, he candidly approves what the Commission had done, suggesting only that it was perhaps handicapped by not having in evidence before it *exactly* the right index to use as a translator. For the purpose of stabilizing the dollar, however, which is a matter necessarily involving the same factors as the purchasing power of the dollar, he reaffirmed the view he had previously written in an article, that any one of several indices used by the Commission would have produced satisfactory results (I, 299). Considered as a whole, therefore, Dr. King's testimony expressly corroborates the Commission's method.

The objection that can be urged against this method of adjusting prudent investment to express it in current dollars, where large bond issues with fixed rates of interest are involved, does not apply to this Company, whose ownership is represented almost entirely by stock equities. What the stockholders of this Company have a constitutional right to demand is a fair "real" income. (See Mr. Smith's testimony, I, 447-450, and II, 891).

This result is achieved by first conforming the rate base to present dollars; and second, finding a fair present rate to be earned thereon. The result would not be attained by keeping the base rigid (*e. g.*, at cost), and changing the rate of return to the fair present rate; the rate would, instead, have to be fixed above or below *current* rates to equalize the excess or deficiency in the base, depending on whether the cost when incurred was predominantly at levels lower or higher than current levels.

In an article entitled "The Economic Merits of Original Cost and Reproduction Cost", in 41 Harvard Law Review 593, Professor James C. Bonbright discusses this very question. At page 600 he says:

> "It is true that if a choice must be made between prudent investment in its unmodified form and reproduction cost then the former basis is likely to result in a less serious fluctuation of real incomes than is the latter basis. But one should not rest content to make this choice of evils without seeking a way out of the dilemma. A possible way lies open. It is to accept the standard of prudent investment, but to make the measure of that investment, not the historical *money* cost, but the historical *real* cost. In other words, the rate base might be made to vary, not with changes in the cost of railway construction, but rather with changes in an index of the cost of living."

It was because the Commission was not willing, in Mr. Bonbright's language, to rest content with this choice of evils, that it has sought by careful study a method which we submit to this Court is a sound and practical economic expression of the legal conception of present fair value. With the greatest respect, we believe that the learned District Court, in its conscientious zeal to establish rigid prudent investment as the minimum non-confiscatory rate base in the Maryland District, failed entirely to apprehend the purpose and effect of the Commission's

method. Thus the Court (I, 558) dismisses the Commission's careful approach to the problem of value as a mere summary device "to save the time and expense that would be involved in a physical appraisal", and contrasts it with the Company's elaborate calculations.

It is thus, perhaps inadvertently, made to appear that the Commission blundered into a slipshod short-cut, whereas the Company produced full details in support of its reproduction cost method—a method which the District Court itself would not accept. The Court further says that the Commission "disregarded" this evidence of the Company. The Commission did not, any more than the Court, *accept* the Company's reproduction cost less depreciation of $48,100,000; but in view of the Commission's thorough analysis of this evidence (I, 23-32), it is scarcely just to the Commission to say that it "disregarded" the Company's elaborate proof. That it is not necessarily error for the Commission to refuse to be bound by a utility's evidence of reproduction cost, is only another way of saying that it is for the Commission and not the Company to find fair value. And see *Georgia Railway & Power Co. vs. Commission*, 262 U. S. 625; *Los Angeles Case*, 289 U. S. 287.

At the risk of tiresome repetition, we again remind this Court that all that has been said in this discussion of the Commission's valuation as such, takes no account of the "cushion" or excess net return of nearly $400,000 allowed by the Commission to absorb whatever increase might be manifested in general price levels after the date of the Commission's determination. Capitalized at the rate of return of 6% found by both Commission and District Court, that margin reflects an increase in rate base of several millions of dollars. When, if ever, prices again go up and stay up on a relatively permanent level, to the extent that this margin is definitely and demonstrably overcome by such stable high levels, the Com-

mission is always open to the Company. It is idle to hope for such solid and sustained recovery while the Government must pour out billions of dollars to keep millions of our people alive.

(b) The Commission's allowance for going value was fair and reasonable.

In finding the illusive element of going value, which it recognized must be allowed, the Commission actually made a double allowance. In the first place, it valued the whole property as a going concern, including all of the integrating, capitalized overheads which have gone into it (see Mr. Smith's testimony, I, 427-429; II, 873); that is, not bare bones of physical plant, but "an assembled and established plant, doing business and earning money". *Des Moines Gas Co. vs. Des Moines,* 238 U. S. 153. In the second place, the Commission took the separate allowance found by the District Court in the 1925 case, and trended it, as that Court had done, to current price levels, resulting in a specific allowance of approximately $732,000 (I, 65-69). It is submitted that this second allowance was not necessary to escape confiscation, but the Commission felt it was proper to make it.

(The Company's evidence of going value, offered through its witness Mr. Sloan, will be discussed separately in connection with our analysis of the Company's so-called reproduction value, since it was offered as a part of that total.)

The Commission believes there is an obvious duplication involved in the Company's position that expenses allowed in the past should now find their way back into the rate base, under the name of going value, in addition to the capitalized overheads which are properly reflected in historical cost of plant. The expenses of attaching business, etc., cannot both be charged as opera-

ting expenses and also allowed as acquisition of capital. In the 1925 District Court case, Judge Rose stated the situation aptly, at 3 F. (2d) 949:

> "It is possible to lay a finger on some of the great differences between the Company's experience and the experts' opinions. Each of them takes into account what one of them calls 'cost of establishing business' and the other 'going value'. Their estimates on this score are many times as great as any amount which the Company expended for that purpose. The Company in 1914 was some thirty years old. It had long before incurred and paid all of the charges for bringing it into the world and for nursing it through infancy, childhood, and adolescence to the full stature of manhood. At that time the Commission allowed it $705,000, to make good what its nurture and education had cost. Apparently it was then quite contented with what had been done. Since then, every dollar that has been used for extension purposes has been treated as an ordinary current expense, and so charged against rates. Mr. Sloan's estimate of the value of this item is $5,388,575, and Mr. Robinson's $4,324,424. Even upon the justifiable assumption that the $705,000 allowed by the Commission in 1914 is equivalent today to almost $1,100,000, Mr. Sloan's estimate is nearly four times as great and Mr. Robinson's nearly three times."

See also *New York Telephone Co. vs. Prendergast*, 36 F. (2d) 54, 64; *Des Moines Gas Co. vs. Des Moines, supra*, 165-6; *Dayton Power & Light Co. vs. Commission, supra*, 309; *Columbus Gas Co. vs. Commission, supra*, 411.

In the *Los Angeles Case, supra*, at 313-4, the Chief Justice said: "The concept of going value is not to be used to escape the just exercise of the regulatory power in fixing rates, and, on the other hand, that authority is not entitled to treat a living organism as nothing more than bare bones." The Commission has valued the actual integrating overheads, which are the nerves, sinews, muscle, flesh and blood, transforming the plant items into

an assembled, working body (II, 875). A specific and separate allowance of $732,000 has been added for good measure. Holding steadily to the necessary demarcation between good will and going value (289 U. S. 313), it cannot be said that the failure to accept Mr. Sloan's bewildering estimate, based partly on what courts have allowed in other cases (I, 269), necessarily produces confiscation.

V. ACCRUED DEPRECIATION.

(a) The Commission's deduction for accrued depreciation was fair and reasonable and was based on substantial evidence, and in fact the only evidence offered of impairment in value.

(b) The amount deducted for accrued depreciation in the Company's proof was admittedly insufficient to include all factors of such depreciation.

To arrive at present fair value of the physical plant, accrued depreciation must, of course, be deducted from gross value. The Commission had before it two evidences of accrued depreciation. It had first, the depreciation reserve, built up out of annual depreciation rates, less annual retirements; and second, it had the observed *deficiency in operating condition*, offered by the Company through Mr. W. F. Sloan (whose testimony was before this Court in the *Chicago Telephone Cases*, 282 U. S. and 292 U. S.). Mr. Sloan frankly admitted that his observation and resulting estimates were restricted to operating efficiency of the property, and that he was "not concerned with value" (I, 274). His estimates on this basis were about 13% depreciation for 1932 and about 14% for 1933. To the District Court he admitted that he would have to change his estimates if he were try-

ing to find impairment in *value*, but he could not say how much he would add (I, 275).

The Commission concluded that the existing reserve, trended in the same manner as the physical plant to express its value in current dollars, was the best evidence before it of accrued depreciation. The trended reserve represented 18.4% of the trended gross value, though the reserve on the Company's books, as of December 31, 1932, was 20.46% of cost. As Mr. Sloan's estimate admittedly did not include the factors of age and value, the difference between his figures of 13% and 14%, and the Commission's 18.4% could be accounted for by this omission, if such reconcilement were important.

We commend to this Court the Commission's detailed treatment of accrued depreciation in its opinion (I, 46-56). Much that counsel might argue would be no more than repetition of what the Commission has there said, clearly and persuasively.

In approaching this matter, one must again recall that the issue involved is whether the Company has proved "by evidence too strong to be rejected" that the impairment in *value* in the plant is less than the trended reserve deducted by the Commission; or, to put it another way, that the deduction of the trended reserve necessarily produces confiscation, "clearly and beyond all doubt." (See detailed argument on burden of proof, pages 40-49.)

As a background to this treatment of accrued depreciation, as the Commission in the present case notes fully, the Commission in 1916 had permitted, in fact encouraged the Company to build its reserve from 14.77% in 1914 to 20%, upon the express understanding that 20% should also be considered as the extent of impairment in value (II, 978). This the Company accepted, but in 1924 thought better of it, and introduced the current contradiction of subtracting *physical efficiency* from gross

value, on the pretext that the result would be measurable in dollars. Judge Rose, with characteristic insight, repudiated that ingenious effort in the 1925 District Court case. His remarks, at 3 F. (2d) 952, quoted in the Commission's opinion (I, 49), are here reproduced:

> "The evidence offered by the Company has failed to convince us that its plant as it stands today is worth more than it would cost new, less the amount now to the credit of the depreciation account.
>
> "In 1916 the Commission, apparently with the full approval of the Company, allowed it, as the exigencies of its business permitted, to accumulate a depreciation reserve not to exceed 20 per cent. of its capital, and expressly stipulated that such depreciation reserve so set apart should not be included in the capital upon which the Company was entitled to earn a return from rates. We do not hold that there was any agreement between the Commission and the Company in any sense which could be enforced by a court of equity, or that what was done amounted to an estoppel *in pais;* but we do hold that it is evidence of what both the Commission and the Company felt then was the amount of depreciation reserve which the Company should accumulate if it was to be kept in such a financial condition as would be safe both to its stockholders and to its patrons. We think that that concurrence of view is strong and weighty evidence that a depreciation not in excess of 20 per cent. is not more than may be fairly held to be the average actual depreciation of the plant. As already stated, there is in our view nothing in this record to prove that there was any error in the estimate then agreed upon."

The acquiescence of the Company in this procedure puts a strong color on the present claim of confiscation, and gives special circumstances to the practice as applied to this Company.

The Company strenuously urged before the Commission that Mr. Sloan's observed impairment in function

was approved by this Court in *McCardle vs. Indianapolis Water Co.*, 272 U. S. 400, 416, in which Mr. Justice Butler said that the testimony of valuation engineers "is to be preferred to mere calculations based on averages and assumed probabilities." Let it be here noted once and for all: First, that the estimates of engineers "preferred" in that case were both based on age and probable future life, neither of which Mr. Sloan considered; second, the "mere calculations" criticized by Mr. Justice Butler were based on straight line computations, and amounted to 25%. For the purpose of showing how the trended actual reserve differs from this "mere calculation," the Commission's Chief Auditor, Mr. Smith, was asked to prepare a computation on the same basis as the one rejected in the *McCardle Case* (II, 876). That figure would have been $13,906,000, far more than the $7,318,000, which the Commission did deduct. The exhibit was introduced solely to forestall the Company's continued contentions (1) that the Commission was doing what this Court had disapproved, and (2) that Mr. Sloan's observation of efficiency was approved by this Court. The complete answer is, Mr. Sloan did not do what this Court "preferred"; and the Commission did not do what this Court criticized. See the thorough discussion of this phase of the *McCardle Case* by Commissioner Eastman in the Interstate Commerce Commission's report on depreciation, 177 I. C. C. 351, 402-408, wherein he points out the inconsistency of the A. T. & T.'s position in claiming *value* in depreciation expense to be given, and *condition* to be taken away.

The Maryland Commission's position in this matter emphatically does not imply that the reserve is, as such, in all cases the best measure of accrued depreciation. In fact, the Commission did not here, or in previous cases, deduct the actual reserve. But it has felt since the 1916 Commission case, that under the circumstances about

20% represents impairment in value. Since 1916 (as of 1914) the Commission has been careful to maintain the reserve. Since being built up from 1914, it has varied but little from an average of 20% until 1933, as the following table shows (II, 875-6):

Year	Per Cent.
1914	14.77
1915	16.17
1916	17.89
1917	20.58
1918	19.50
1919	21.40
1920	22.55
1921	24.07
1922	24.58
1923	23.26
1924	20.84
1925	19.30
1926	18.67
1927	19.34
1928	20.03
1929	20.87
1930	20.08
1931	19.95
1932	20.46

This uniformity is strong evidence that the turnover of property had reached a comparatively stable rate, and that the average of ages in the plant had become balanced as new items replaced old ones. The Company argues that the reserve must always be larger than actual depreciation because the reserve represents in part the provision for eventual retirement of young items of a growing plant in which impairment is not yet observed. Besides begging the question of value, this argument makes an assumption which is demonstrably contrary to fact. This plant was started in 1884, and we are now considering a period just fifty years later. Must we to the end of time refuse to recognize loss in *value* "because

the plant is young and growing"? Mr. Justice Butler in his concurring opinion in the *Lindheimer Case* expresses it aptly when he says (292 U. S. 181):

> "The company's properties constitute a complex and highly developed instrumentality containing many classes of items that require renewal from time to time. But, taken as a whole, the plant must be deemed to be permanent."

But even assuming that the plant were young, and that the reserve were greater for that reason than the loss in *efficiency*, it does not follow, as the Company contends, that a piece of property in 90% operating condition has 90% of its original *value*. A telephone instrument may have served 50% of its normal life and Mr. Sloan may find it in 90% physical condition. Its value in dollars cannot be 90% of its value new. Loss in value sets in from the day of installation, since all property (if we except works of art and similar objects) is "on an irresistible march to the junk heap, whose progress can be retarded, but never arrested." The straight line method of estimating current loss in value is a rough formula for dividing that loss equally over the service life of the property. The curve of loss in efficiency starts out fairly flat and rises sharply toward the end of service life. The curve of loss of value is more uniform, and starts upward immediately. (See *Knoxville vs. Knoxville Water Co.*, 212 U. S. 1, 10.) Thus a uniform reserve, built up by depreciation rates carefully watched by this Commission, tends to approximate the true loss in value in proportion to the accuracy of the estimates. If it is fair, as the Company and Commission and the I. C. C. agree, to treat present and future subscribers alike in computing current depreciation rates so long as conditions remain the same, there seems no logical reason why it is not fair to treat present and future subscribers alike when it comes to deducting a reserve carefully built up on the

same principle. The Company was allowed service value when it took depreciation expense, and now cries confiscation when Commission and District Court take it at its word.

In *New York Telephone Co. vs. Prendergast*, 36 F. (2d) 54, 66, Judge Manton, with the *New Jersey Telephone Case, supra*, and the *McCardle Case, supra*, expressly before him, made this observation:

> "Therefore, the necessity for finding essential facts creates the necessity for using not what evidence might be desired, but the best of which the subject admits. Either the property has in fact depreciated to the extent of the depreciation reserve which has been created, or it has not. If it has not, the plaintiff has been allowed to take money from its ratepayers under the claim of depreciation which was not there, either seen or unseen, and which it will never have to admit. In that case, the excess reserve has been acquired lawfully and is the property of the plaintiff. But if the actual depreciation exists to the extent that the plaintiff has claimed in building up this reserve, it exists as much for valuation purposes as it did for the creation of the surplus. *Whether or not the plaintiff admits the depreciation now, or must do so in the future, is unimportant, for it is there, and the time of its admission is immaterial on the question of its existence.* If, as claimed by the plaintiff, sound honest business methods have been followed and the straight line method pursued by it was not excessive, the depreciation reserve, when added to the property now or at any ti[illegible] would be no more than sufficient to keep the actual value of the property constant. The record satisfactorily shows that there is more reason to believe that the actual existing depreciation in the plaintiff's property is reflected by the amount of its reserve for depreciation than that it is shown by the estimate of experts who stated observed depreciation, which sum only was deducted by the master. For these reasons, the plaintiff has failed in the burden, resting upon it, to prove that the re-

serve depreciation was greater than the actual depreciation, both seen and unseen, as measured by the depreciation reserve." (Italics ours.)

In the discussion of the Company's underlying assumption that value and efficiency are the same, one further refinement should perhaps be made explicit. We do not suggest that the impairment in value which sets in at once in new telephone property goes up on the same sharp curve as the purely psychological loss in sales value which an automobile, for instance, sustains the day it is purchased. But we do stand on the simple truth that a piece of telephone property which has served 50% of its useful life and is in 90% observed operating condition, has lost more nearly 50% than 10% of its rate base value. We say "more nearly" in recognition of the judgment nature of all such estimates. It should be recalled, too, that such value as property may still have when retired, if any, is credited in the form of salvage before estimating current depreciation expense, so that in terms of dollars, service value and rate base value are thus reconciled in the balance to the depreciation reserve.

The Company's dual legal theory as to current depreciation and accrued depreciation therefore originates in a logical contradiction, and having started off on that angle of deflection, no amount of expensive and technical engineering data, impressively graphed, which the A. T. & T. persistently offers in these cases, can reach a result which bears thoughtful analysis. On the contrary, the original error is only the more exaggerated. This being the Company's legal theory, Mr. Sloan's testimony is obediently and frankly shaped to that theory. While we trust the Court will read all of Mr. Sloan's cross-examination on accrued depreciation, which covers only six pages of the record (I, 272-278), we reproduce here two

excerpts which baldly expose the Company's depreciation dualism. At I, 274, Mr. Sloan says:

> "When it is retired, from whatever cause, it costs the Company money. All I am trying to tell you is the condition that the property is in. Most of the causes of retirement do not affect the physical condition of it in the slightest degree. I am not concerned with value, I am concerned with the condition of the property, and I am trying to tell you from an engineering standpoint what condition this property is in."

Later, after being pressed by Judge Soper (I, 275), he states the same thing even more plainly:

> "Illustrating this with the case of copper wire, the copper wire may be down in 5 years from now; we will say it has been there 15 years, and you know it is coming down in 5 years; that would mean that three-fourths of its life was gone on that theory. But that is not what I have done. I have observed that wire, and find that it is practically as good as it was when it was put up there. I think that is what accrued depreciation actually is. The things that shorten the life and cause it to come down are things that do not affect its physical condition at all. *I think you should consider that these causes do affect the dollars out of the Company's pocket, but I think you should also know what condition the property is in from a physical standpoint. The other figure is a thing you should ask for from the accounting people.*"

It may be noted that the valuation of the Illinois Commerce Commission, sustained by this Court's action in the *Lindheimer Case, supra*, 175, deducted the entire reserve of the Chicago Company for 1922, which was then $26,000,000, or 30.44%. See P. U. R. 1924 A 213, at 231-237. This may be compared with the 18.4% trended reserve deducted by the Maryland Commission. While we are aware that this Court did not need to discuss th

point in the *Lindheimer Case*, it provides an interesting comparison. (In fact, a close analysis of the action of the two commissions in other respects as it affects the earnings of the two companies, puts the liberality of the Maryland Commission in a strong light. Ordinarily such comparison might be misleading, but it has persuasive bearing when the two companies are operated by the same parent, with uniform practices and policies, and where the same evidence is presented for the two companies, even by some of the same witnesses, in almost identical language.)

Summarizing this discussion of accrued depreciation: The Company's evidence is admittedly incomplete, as it ignores value; the reserve of approximately 20% was created by the Commission at the Company's request upon the full understanding that 20% measured actual depreciation in value, which was acquiesced in by the Company until 1924; since 1916 the reserve has been uniformly around 20%; the Commission in this case deducted the trended reserve of 18.4%; the practice was approved by the District Court in 1925 and the principle of it is approved by the same Court in 1934.

In the light of the foregoing, we respectfully urge that this Court cannot say, in the words of Mr. Justice Holmes, that it is "impossible for a fair-minded board to come to the result which was reached"; or that the Company's incomplete proof has made out, by "evidence too strong to be rejected", that the Commission's deliberate consideration on this matter produced a result which the Constitution forbids.

VI. WORKING CAPITAL.

The Court erred in finding and including as a part of the rate base, working capital in the amount of $1,000,000.

(a) The amount allowed by the Commission for working capital was a finding of fact based on substantial evidence, and was fair and liberal.

(b) The amount claimed by the Company for working capital was erroneously computed and was excessive.

The amount allowed by the Commission for working capital was a finding of fact based upon substantial evidence and was fair and liberal. The Company claimed that $1,625,000 should be included in the rate base as working capital. The Commission allowed $660,863. The Commission recognized that every successful business must have sufficient cash, materials and supplies with which to pay its expenses as they mature, and to use in its day-to-day operations. Working capital is indissolubly identified with expenses and with the amount of materials and supplies which the Company must always have on hand to satisfy its operating requirements. The Commission followed the usual practice and allowed the Company a reasonable amount of cash and materials and supplies for its working capital requirements (I, 69-72).

The cash part of the working capital was fixed as 25/365 of the Company's operating expenses as adjusted by the Commission. There is a twenty-five day lag between the rendition of service and the collection of revenues. Hence, the Company requires a cash working capital sufficient in amount to pay its expense bills during the twenty-five day period. The 25/365 of expenses allowed by the Commission was intended to and did represent the amount of cash which the Commission allowed the Com-

pany as its cash working capital. In allowing 25/365 of the operating expenses as adjusted, the Commission was generous to the Company, because all of the expenses incurred in a period of twenty-five days are never actually paid during that time, but because of commercial practices of paying bills ten days and even thirty days after date, the Commission's method resulted in allowing the Company more cash than it would ever be required to expend prior to the time that it makes collections from its customers.

As stated above, the Commission allowed as cash working capital, operating expenses for a twenty-five day period. The operating expenses, however, were the book expenses after certain adjustments necessary to determine the *expenses which require working capital*. Thus, depreciation expense was eliminated, because depreciation expense is a non-cash expense and therefore requires no working capital. The pension note accruals were likewise eliminated because the giving of notes does not require working capital. The payment of pensions does require working capital and the aggregate amount of such payments was included by the Commission in its determination of working capital.

There are certain utility expenses for which working capital is not required, because they are included in the rates charged customers for service, and the customers are obliged to advance such expenses long before the utility is required to meet them. Thus, the customers advanced the Federal income tax expense throughout the year 1934, although the Company is not required to pay the income tax so collected from the customers until the year 1935. Other taxes which are collected from the customers prior to payment by the Company were likewise eliminated by the Commission from the operating expenses as recorded in the books of the Company, in computing the expenses for which working capital is re-

quired. It would be most unfair to the consumers to allow as part of the cash working capital a proportionate part of the non-cash expenses; and it would be even more unfair to compel consumers to pay a return on working capital held for the payment of taxes when the consumers are required to advance the taxes to the Company long before the Company is required to turn over the money thus collected to the taxing authorities.

In computing the material and supply element of working capital, the Commission allowed the Company the average monthly balance of the materials and supplies it had on hand. In addition to the materials and supplies which the Company reflected in its books and which it actually had in its possession, the Company claimed, but the Commission refused to allow, approximately $158,000, representing what the Company calls Class C materials (II, 757). These represent, according to the Company, "recovered" material returned to the Western Electric Company for repairs and temporarily held by that company for the order of the Telephone Company. The Western Electric Company, while it may hold the materials for the order of the Telephone Company, has full control over the materials and may dispose of them in any manner it sees fit. They were not in the possession of the Telephone Company, *nor does the cost or value thereof appear in its books.* The Commission was urged to include Class C material in its finding of working capital, but it refused to do so, stating that it was not owned by the Telephone Company. Even if it were, however, it would appear to be property not used or useful in rendering service.

The Company's claim for working capital is likewise divided into two elements: first, materials and supplies; second, working cash. The only difference between the Company and the Commission in the materials and supplies element is the Class C stock mentioned above, which

the Commission justifiably refused to allow. The Company subdivides its cash working capital into three parts:

(1) General Cash.
(2) Employees' Working Funds.
(3) Service Rendered in Advance.

Items (1) and (2) represent the average cash which the Company had on hand, both in its general cash accounts and in its working fund accounts during 1933. The cash was the total corporate cash, hence was available and was used for total corporate purposes, such as the payment of interest and dividends (which payments should come out of the return and are not related to working capital) as well as for ordinary utility operations.

The amount of cash actually possessed by the Company is not, of course, an accurate indication of the amount of cash required for working capital purposes for two reasons: first, because it is the general corporate cash and may be larger or smaller than actually required in the utility operations; and second, because the cash account may be unduly augmented because of heavy borrowings from banks, affiliated companies, or the flotation of security issues in preparation for construction work, refunding or other functions not connected with the ordinary operations of the Company.

In Item (3), Service Rendered in Advance, the Company applies the familiar principle of computing working capital by recognizing the twenty-five day lag between the rendition of service and the collection of revenues. While the Company's method is correct in principle, it is applied in a most erroneous manner, for the twenty-five day lag (25/365) is applied, not to operating *expenses* for which the cash must be held available, but to operating *revenues*, a much larger sum.

Cash working capital is not held by business institutions to meet any requirement of revenues, but rather for the purpose of meeting requirements of operating expenses. Item (3), Service Rendered in Advance, is classified by the Company as part of its required working cash capital. In other words, the item represents a computation of what the Company claims it needs as cash working capital for the purpose of conducting its operations, but in view of the fact that Items (1) and (2) under working capital represent the cash *actually held by the Company*, there is an obvious duplication, for the Company claims as cash working capital not only the average cash it had on hand, but even additional cash of a much larger sum which it did not have. Thus the Company's computation defies the basic principle applicable to the ascertainment of cash working capital, namely, the determination of whether the Company's actual cash is more than required for cash working capital; for certainly the Company should not be allowed to earn on a larger cash working capital than it actually has invested in the business.

(c) The amount found by the Court was an arbitrary round figure and based on no specific evidence.

(d) The Court erred in substituting its judgment for the judgment of the Commission, because the proof of the Company was lacking in the force legally required to establish that the Commission's finding was clearly wrong.

The District Court in this case found an arbitrary lump sum, round figure of $1,000,000 for working capital. The Court rejected the Company's claim of working capital and substituted its own judgment for that of the Commission by adding to the Commission's determina-

tion the Class C stock which the Commission specifically disallowed, and by adding an unspecified sum, arrived at in an undisclosed manner, because of the fact that *cash was deposited with numerous depositories.* It is quite evident that the $1,000,000 was the cause and not the effect of the Court's reasoning.

Speaking of Class C materials, the Court says (I, 572): "Of this amount ($407,452) the Commission disallowed $158,048 on an understanding of the facts shown to have been incorrect by the testimony in this case." The misunderstanding, with great respect, was that of the District Court, for the Commission considered Class C stock, discussed the item in its opinion, understood the facts thoroughly, and specifically held that the item had no place in working capital (I, 71-72).

The Court fell into the error of comparing the amount of working capital with the value of the Company's other property. Obviously such comparison is misleading. Working capital is not related to property but to expenses and, secondly, the amount of working capital which must be held available for expense payments depends on whether customers are billed in advance (a substantial telephone practice) or after rendition of service. Every business man knows that the longer the term of credit, and the slower the turnover of accounts receivable, the larger the working capital must be.

There could be no clearer illustration of the District Court's assuming functions which are delegated solely to the Commission, than the Court's action in valuing working capital. The Court does not bother to show that the Commission was wrong, nor is it concerned with burden of proof; it simply substitutes its own judgment for that of the Commission and arrives at an arbitrary—almost capricious—amount of $1,000,000. The Commission's allowance for working capital was a finding of fact determined in a scientific manner from a careful considera-

tion of detailed evidence on each element thereof, and we respectfully suggest that the Court erred in gratuitously entering this debatable field of fact and in arbitrarily choosing another amount *without even prescribing the method of computation. Clark's Ferry Bridge Case*, 291 U. S. 227, 240. In the language of Mr. Justice Cardozo, the "amount necessary for working capital was carefully computed, and has not been proved to be too small for the requirements of the business." *Dayton Power & Light Company vs. Public Utilities Commission, supra*, 311.

While the amount allowed for working capital is not of itself important in this case, the approach which the District Court made to this question of fact is illustrative of the misconception of its function in passing upon the evidence and the burden of proof which pervades its whole opinion. In discussing the allowance for depreciation expense we have treated fully the District Court's proper scope of review; see pages 40-49.

VII. THE COMMISSION'S LIBERAL ALLOWANCE OF OPERATING EXPENSES.

The Court erred in failing to give any or proper weight to the allowance by the Commission to the Company of liberal operating expenses for 1934 and subsequent years, the disallowance of which would have been fair, reasonable and non-confiscatory.

(a) The Commission allowed in full as operating expenses the amounts payable by the Company to the Western Electric Company for maintenance and other items, notwithstanding abnormal and unreasonable increases in Western Electric prices.

The A. T. & T. owns all of the common stock of the Telephone Company and over 98% of the stock of the Western Electric Company. The Western Electric Com-

pany is in fact the manufacturing department for the Bell Companies, and it also acts as purchasing agent for them. As of November 1, 1930, the Western Electric Company made a 10.2% advance in prices to the Bell Companies. As of January 1, 1934, a further advance of 10% (I, [illegible]; II, 806) was made by the Western Electric Company. These advances had dual effects; they increased the cost of the new fixed capital or property of the Company, and they increased its operating expenses, because many of the purchases from the Western Electric Company were charged to maintenance accounts in the Company's books. Even the District Court in *Illinois Bell Telephone Company vs. Gilbert*, 3 F. Supp. 595, whose attitude toward the company was certainly generous, made a finding of fact that the 1930 advance in prices was unwarranted. The 1934 advance was not before that Court.

The record does not disclose the exact effect of the advances in prices upon the maintenance expenses of the Company, and the Commission is not now contending that the operating expenses as estimated for the year 1934 should be adjusted and reduced because of such advances. Nevertheless it is important, as illustrative of the liberality of the Commission, and particularly because confiscation is now the issue, to determine the approximate effect of those advances upon the income of the Company. The approximate effect can be obtained by a comparison with the *Lindheimer Case, supra*. The 1930 advance in prices increased the expenses of the Illinois Bell Telephone Company for 1931 in the amount of $332,470 (see Footnote 4, 292 U. S. at page 157). The maintenance expenses of the Illinois Bell Telephone Company for the year 1931 aggregated $10,842,053 (*supra*, at page 174). Thus the maintenance expense was inflated 3.066%. If the 10.2% advance in prices in 1930 had the effect of inflating maintenance expense 3.066%, then the 10% advance as of

January 1, 1934, must have had the effect of increasing the maintenance expense an additional 3.006%, a total increase of 6.072%.

The maintenance expense of this Company, as estimated by it for the year 1934, which is not questioned by the Commission, was $2,208,000 (II, 797). The overstatement of the maintenance expense for the year 1934 must therefore be approximately $134,070 (6.072% of $2,208,000). This overstatement may not be exactly $134,070, but the comparison of like companies operating in a similar manner indicates clearly that the overstatement amounts to certainly more than $100,000.

The advances in Western Electric prices over those prevailing in 1929 were artificial, and were made possible solely because of the relationship of the corporations. That relationship is not sufficient justification for the reversal of the economic tide. When it is remembered that since 1929 the Federal Administration has been engaged in a herculean effort through devaluation of the dollar, domestic allotment plans, R. F. C. loans, direct loans and open market operations of the Federal Reserve Banks, liberal banking laws for issuing bank notes, greater monetization of silver, etc., to restore the price level to near the mean of 1929, and when it is further remembered that the results are still considerably short of the goal,—and when it is further recalled that the Western Electric Company has increased its prices about 20% over its December 31, 1929, level, the achievement of the Western Electric Company is not only amazing, it is incredible.

This Commission does not lend its voice to the current popular clamor against public utilities. It has real respect for the A. T. & T. system, and believes it is as efficient as any organization, suffering from the "curse of bigness", can be. Yet, to sanction the practice of the Western Electric Company as a basis for public rate regulation

would be equivalent to approving a power inherently and legally irresponsible to regulation. Obviously, the power to control public utility costs is the power to defy regulation.

(b) The Commission allowed as operating expenses the full amount of the Maryland Capital Stock Tax, although it is a tax on stockholders on their shares and not a direct tax on the Company's property.

Both the Commission and the Court allowed in the operating expenses of the Company all the taxes which it paid or accrued, including the Federal income tax and the Maryland capital stock tax. The capital stock tax, however, is not a tax imposed on the corporation but on its stockholders, and when the question at issue is confiscation, the facts must be examined in the light of the law of confiscation. Such an examination reveals that the capital stock tax was not a legitimate expense of the Company and should not be considered as such in deciding the confiscation issue. *Banton vs. Belt Line Ry. Co., supra.*

The Maryland capital stock tax is a tax on stockholders of certain corporations and not on the corporations themselves, although for convenience the corporations are made the collecting agents. Section 6 of Article 81 of the Maryland Code provides, in part, for the capital stock tax in the following language:

"The following property * * * shall be subject to assessment to the owner and taxation for ordinary taxes in this State and in the county and/or city specified below * * *.

"(7) All shares of stock in any domestic corporation, other than an ordinary business corporation, in the county and/or city in which the owners respectively reside, or, in the case of shares owned by

non-residents of this State, in the county and/or city in which the principal office of the corporation in this State is situated."

Section 15 of Article 81 provides for the method of assessment of shares of stock taxed under Section 6, and Subsection (e) of said Section 15, the pertinent subsection to our inquiry, provides as follows:

> "Shares of stock assessable under this section shall be taxed to the several owners thereof, and the taxes thereon shall be debts of such owners, but may be collected in each case from the bank or other corporation, which shall be bound to pay the same for account of its stockholders whether or not dividends are declared thereon, as if such corporations were the ultimate taxpayer, but may obtain reimbursement therefor from the respective stockholders, and may charge the same in reduction of any amounts due to the several shareholders as dividends or otherwise."

The sections quoted above are in substance recodifications of the old Sections 157, 163, 166 and 166A of Bagby's 1924 Annotated Code of Maryland. Most of the Court decisions have arisen under the old sections, but the substance of the sections is the same and the decisions unanimously hold that the tax is on the stockholders and not on the corporation.

In the case of *Union Trust Company vs. State*, 116 Md. 368 at page 375, the Court says:

> "It has been repeatedly held by this Court that the tax upon the capital stock is not a tax upon the corporation, but upon the owners of that stock, the corporation being made the medium through which the tax is collected. This is in strict accord and analogy with the case of *Monticello Co. vs. Baltimore City*, 90 Md. 416, * * *."

In the case of *Corry vs. Baltimore*, 196 U. S. 466, beginning at page 560, this Court said:

> "The subjects and methods of taxation of property within the State of Maryland are regulated generally by article 81 of the Code of Public General Laws of that state * * *.
>
> "The Maryland decisions have also settled that the tax is on the stockholder personally, because of his ownership of the stock, and is not on the stock *in rem* or on the corporation."

In *Susquehanna Power Company vs. State Tax Commission*, 283 U. S. 297, the Power Company opposed the assessment of the capital stock tax on the grounds, *inter alia*, that the statute violated the due process clause of the 14th Amendment because it imposed a tax on intangible shares of stock owned by a non-resident. This Court held the statute constitutional and said, at page 299:

> "The court of appeals of Maryland, in upholding the assessment, pointed out that it did not exceed the value of appellant's tangible personal property within the state, and that the tax was in lieu of any direct tax on that property; and sustained it as an indirect tax on the property."

It is true the tax is in lieu of a personal property tax on certain corporations, but nevertheless the tax is not assessed against the corporation but to its stockholders. The Company was not compelled by law to bear the incidence of the tax, as the statute gave the Company adequate remedy to collect the amount thereof from the stockholders, chiefly its parent, the A. T. & T. If the Company did not choose to enforce its rights and obtain reimbursement of the tax from its stockholders, then legally the amount of the tax represents a dividend or a donation to the stockholders and not a *bona fide* operating expense of the Company.

The Commission, as a matter of public policy, has consistently allowed the Maryland capital-stock tax as an operating expense to the utilities under its jurisdiction. The question before this Court is not a question of public policy, but a question of confiscation. The burden of proving confiscation lies heavily upon the Company; the Company must prove confiscation by a portrayal of all the facts, and certainly one of the most important facts to consider is whether the operating expenses claimed by the Company are overstated.

The fact that all taxes paid or accrued were allowed as expenses should also be considered in fixing the rate of return. Since the income tax exemption on the stockholder is "in effect, part of the return on investment," it "must be taken into consideration in determining what rate of return shall be deemed fair." *Galveston Electric Co. vs. Galveston*, 258 U. S. 388.

(c) The Commission allowed as operating expenses in full the labor rates of the Company, although the evidence showed that such rates were higher during the years of the depression than immediately prior thereto.

From 1923 to 1932 the average hourly rate of wages paid by the Company to its construction and maintenance employes increased steadily, the increase from 1929 to 1932 being almost perpendicular (II, 860B). At the hearing below, the Commission did not question the wage rates, nor does it do so now. No adjustments have been made to the operating expenses because of the increase in average hourly rates of pay since 1929 and none is proposed. The Company, however, has charged the Commission with confiscating its property, and in denying this charge it is proper for the Commission to show that it not only has not confiscated the property, but that it has treated the Company liberally by allowing expenses

which might legally have been disallowed. One of such expenses is the increased cost of labor. Since the Company's labor costs were increasing at a time when labor rates in general were descending precipitously, it follows that the Company's labor expense could have been seriously questioned. When it is charged with the very grave lack of fairness involved in confiscation, the Commission urges that such deliberate fairness be weighed and adjudged in its favor.

VIII. INDEPENDENT VALUATION BY THE DISTRICT COURT.

The Court erred in finding that the minimum non-confiscatory rate base of all of the Company's property used and useful in rendering telephone service, as of December 31, 1933, was $39,541,921.27.

(a) The Court's finding was admittedly based on historical cost, which it found to be the same as prudent investment, although the evidence showed that by far the greater portion of the plant was installed during a period of higher prices than those prevailing on the effective date of the valuation.

(b) The Court erred in assuming in its opinion that the cost of the Company's property had been incurred at times and under circumstances and at price levels not greatly dissimilar from those prevailing at the time of the hearing and likely to prevail in the near future.

(c) The Court erroneously accorded "special weight" to historical cost, being led to do so by an erroneous interpretation of the "history of the relations of the Company and the Commission", and of

the history of former rate cases involving the Company, and by an erroneous application of such erroneously construed and irrelevant history to the circumstances of this case.

(d) The Court erred in failing to accord any or proper weight to the evidence of decreased costs of labor and materials prevailing at the time of the hearing as compared with the costs prevailing at the times the properties were acquired.

(e) The Court failed to give effect to the liberality of the Commission, not required by the evidence, in allowing in the fair value fixed by them a substantial excess of plant over and above present requirements for service. (Discussed under IX, d.)

(f) The Court erroneously included in its findings property owned by the Company but not used and useful in rendering telephone service. (See IX, d.)

The law is clearly settled by this Court that historical cost or prudent investment, while it is a relevant fact, is only one of the factors to be considered in arriving at fair value. In the words of Mr. Justice Butler:

> "It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase."
>
> *McCardle vs. Indianapolis Water Company*, 272 U. S. 400, 410.

And the Chief Justice recently said in the *Los Angeles Case*, 289 U. S., at 306:

> "The actual cost of the property—the investment the owners have made—is a relevant fact. * * * But while cost must be considered, the Court has held that it is not an exclusive or final test. The public

have not underwritten the investment. The property, on any admissible standard of present value, may be worth more or less than it actually cost. The time and circumstances of the outlay, and the effect of altered conditions demand consideration."

The amount of weight to be given to historical cost depends directly on the similarity between conditions and price levels when the cost is incurred, and conditions and price levels at the date of valuation. In some cases, as we have noted, the similarity in conditions and price levels has been so close that chief reliance has been justifiably placed upon historical cost. This doctrine was clearly set forth by Mr. Justice Butler in the *McCardle Case, supra*, 411, where he said:

> "Undoubtedly the reasonable cost of a system of water works, well planned and efficient for the public service, is good evidence of its value at the time of construction. And such actual cost will continue fairly well to measure the amount to be attributed to the physical elements of the property *so long as there is no change in the level of applicable prices.*" (Italics ours.)

Before the courts and commissions can give even dominant weight to historical cost or prudent investment as a guide to fair value, the evidence must show that conditions and prices were on substantially the same level at the time the costs were incurred and at the date of appraisal. In other cases historical cost may continue to be one of the relevant facts to be considered, but its probative value necessarily diminishes in direct proportion to the dissimilarity between the two periods.

Mr. Crunden, the Assistant Comptroller of the A. T. & T., confirmed this very obvious fact when he said, "I concede that in the period following the War, that the reproduction cost would have been considerably higher, properly found, than the book cost of the property." (I, 365.)

But he then naively continues, "But it is characteristic of the Bell System in general that reproduction cost and original cost have tended, generally speaking, to come together. * * * I have not seen the figures in this particular case, they cannot be very far apart." (I, 365). Now, in 1925 the Company's two reproduction cost appraisals were about $42,800,000 and $38,000,000, net (3 F. (2) 948), while "original cost," net, including capitalized going value and working capital, was about $22,500,000. When the reverse price conditions prevail in 1933 and 1934, however, we find the Bell System ("characteristically", to use Mr. Crunden's language), presenting reproduction cost and original cost values very close together. The inference is pretty clear. In the period of high prices following the war, in 1925, the Company's net reproduction cost, "properly found" we assume, was actually from 68% to 90% higher than net cost. In the reverse conditions of the present low level of prices, it appears that the "properly found" reproduction cost gives way to the "characteristic of the Bell System," for even in 1933 the Company's reproduction value net is higher than net cost and almost the same as gross cost (II, 798). It is certainly a mild comment on this testimony of Mr. Crunden to say that he admits, as indeed the facts prove abundantly, that the "Bell System" has not offered to the Commission or the District Court in this case, evidence of reproduction cost "properly found." The Company imposed on the Commission and the District Court either in 1925 or in 1934. Was this "characteristic" evidence of the Company of such compelling nature that this Court can say that it was *necessarily confiscation* for this Commission to find a stated value less than cost in 1933—to say nothing of the Commission's extra allowance in net return which has the practical effect of bringing that value very close to cost?

Whether historical cost *must* be adopted as the *measure* of the rate base, notwithstanding fluctuations in the level of general prices, was an issue conclusively determined in the negative by this Court in the *Southwestern Bell Telephone Case*, 262 U. S. 276. The argument in favor of prudent investment could never be better presented than in the classic dissent of Mr. Justice Brandeis. With prophetic insight he there foresaw and described the results of the application of the doctrine of *Smyth vs. Ames*, 169 U. S. 466, when the era of prosperity and high prices should be at an end. Notwithstanding that argument, this Court, through Mr. Justice McReynolds, definitely and conclusively repudiated the doctrine of mandatory prudent investment and confirmed, as a matter of constitutional law, the fluctuating conception of present fair value.

In later cases this Court has also had occasion to issue warnings against the danger of giving too much weight to another relevant fact, namely, reproduction cost new, even in periods of changing prices, where the appraisal contains too much of hypothetical assumption and conjecture. But in none of its decisions, we submit, is there any indication that this Court is willing to depart from the rule on which the Court divided in the *Southwestern Bell Telephone Case*. The principle of that case has been repeatedly reaffirmed. To depart from that well considered rule now, simply because the economic situation is the reverse of the situation existing when the *Southwestern Bell Case* was decided, would be to enact a double standard and permit public utility interests to have at all times present fair value or prudent investment, whichever is higher. The fact that this Commission followed, but at the same time improved upon, the method adopted by the District Court for this Company in 1925 merely illustrates its obedience to the law finally determined by the *Southwestern Bell Telephone Case*. We submit that

the Commission's action cannot be regarded as error, much less unconstitutional and confiscatory, because it followed that law.

The interesting thing is that the District Court in the case at bar also clearly enunciated the proper rule and set it forth several times in its opinion. For instance, it says:

> "But where actual cost data are available and reliable and represent the actual expenditures for the public service *under conditions reasonably approximating those prevailing at the time of the rate inquiry*, cost has been given very great weight in determining present value" (I, 536-537; italics ours).

We have no quarrel with this statement of the law, but we respectfully submit that what the Court did differs from what it said. For the Court goes on to state that it has given "dominant weight" and "special weight under the facts and circumstances of this particular case to historical cost", which it compares to the prudent investment. To give historical cost special weight under the circumstances of this case is, we submit, clear error.

The Court attempts to find such special circumstances of this case in an erroneous interpretation of earlier cases involving this Company, decided by the Commisson prior to 1925. Even if such cases could have, with *their* different circumstances, any legal bearing on value in 1934, the fact remains that in none of those cases did the Commission adopt cost as a measure of value. Reference to the 1916 Commission case will show that a complete appraisal was there used (II, 923), and the 1920 and 1924 Commission cases were based thereon. The circumstances of *this* case to which weight must be given are not those former Commission cases decided in a different era on a different basis, but rather the drastic decline in values of all types of property since 1929. The *relevant*

circumstances of this case demand that historical costs of a high price period must *not* be given "dominant" or "special" weight, much less exclusive weight. In this connection, with great respect, it seems strange that the District Court in 1934 should chide the Commission for following the same Court's decision in 1925, and for not following the Commission cases, particularly as the basis for that reproach is grounded in such a palpable misconception of what the Commission did in 1916, 1920 and 1924. From the Court's present opinion one gets the entirely erroneous impression that the Commission was wedded to prudent investment before 1925, and that the 1925 District Court case was only an aberration which "it is hoped" can hereafter be corrected. The District Court was simply mistaken in the facts about the earlier Commission cases, and magnified the error by applying mistaken facts to an erroneous legal assumption in regard to those earlier cases.

Actually, the Court not only gave historical cost and prudent investment dominant and special weight, *but it adopted historical cost down to the very last penny as the actual measure of the rate base*, thus giving it, regardless of its language to the contrary, exclusive weight. That the District Court is wedded to the doctrine of prudent investment and a non-fluctuating rate base in all circumstances is disclosed by several statements in its opinion. For instance, in a footnote (I, 549), after noticing that the Company employed its high labor rates in its appraisal, the Court remarks:

> "This illustrates the view that the cost of reproduction is inherently a method of valuation less satisfactory than historical cost in this case."

And at another place (I, 553-554) it uses this language:

> "It is also relevant to the case to point out that, as fair valuation in this case is the same as book

> cost less depreciation reserve, further rate litigation, so expensive primarily to the Company and ultimately to the public may, it is hoped, be avoided and subsequent changes in the rates when necessary in fairness either to the Company or to the public can, it is hoped, be met by action of the Commission in reducing or increasing the rate of return. The re-establishment of book value less depreciation as the rate base will also enable the Commission to return to the principle of valuation which obtained prior to 1925 and was then regarded by the Commission as fixed and final."

In connection with rate of return the District Court also says (I, 581):

> "With the rate base re-established on the basis heretofore approved by the Commission (and accepted by the Company prior to 1925) it is reasonable to anticipate that further valuation proceedings (with the expense and detail occasioned thereby) will be unnecessary and that further revision of the rates, if necessary, can well be related to adjustments of the rate of return to be allowed the Company from time to time."

These expressions cannot be reconciled with any other conclusion than that the District Court does not now accept the settled rule of fair value but instead accepts rigid prudent investment, not only for this case, but as a general principle for "further valuations." The District Court fell into this error partly because of the erroneous interpretation it placed upon this Court's decisions in the *Los Angeles Case, supra,* the *Clark's Ferry Bridge Case, supra,* and *Dayton Power and Light Company vs. Commission, supra,* which authorities it cites in support of its action (I, 537). If the Court construed these authorities to uphold the proposition that historical cost or prudent investment *must* be taken as the minimum non-confiscatory value as of December 31, 1933, of properties

90% of which had been acquired and installed in the era of phenomenally high prices following 1917, we respectfully submit that its error can be exposed by an analysis of those decisions.

In the *Los Angeles Case* this Court held that since two-thirds of the cost of the properties had been incurred after January 1, 1922, a figure, *fixed by the California Commission,* slightly above historical cost, less the value of certain partially disused facilities, was a proper criterion of value as of December 31, 1930, which the California Commission, since it saw fit to do so, *could* adopt. Noting the Bulletin on "Wholesale Prices", United States Department of Labor, February, 1933, and the high level of prices obtaining from 1917 to 1926, this Court felt that it was *not unfair to the Company* to consider historical cost incurred 1917 to 1930 as a criterion of value at a time when the present depression was only in its initial stage. It is, of course, one thing to affirm the Commission's action in adopting historical cost and quite another thing to hold that the Commission's order was necessarily and *ipso facto* confiscatory in refusing to adopt it. The case at bar may be likened to the situation in the *Los Angeles Case,* in that more than two-thirds of this Company's property, as much as 90% thereof, was acquired in the high price period. The case at bar differs from the *Los Angeles Case* as to the respective dates of valuation, and also in the fact that in our case the Commission itself recognized that it would be improper, considering the rights of the ratepayers, to give controlling weight to historical cost when such costs were incurred in a "different economic era".

In *Dayton Power and Light Company vs. Commission,* this Court inferentially approved a figure equal to historical cost as the rate base for November, 1932, taking it perforce "for lack of anything better." Here again the decision was that the *commission,* if it saw fit, *could*

take historical cost, and not that it was *required* to adopt it as the minimum non-confiscatory rate base. "If the evidence would have been adequate to uphold a lower rate, *a fortiori* it was adequate to uphold the rate prescribed."

In the *Clark's Ferry Bridge Case*, this Court held that it was not *confiscatory* to fix a rate base as of February, 1932, slightly above the cost of a bridge site and a bridge constructed May, 1925, inasmuch as the lower Court had before it general index numbers of construction costs which showed that the trend in prices from 1924 to 1932 was "downward rather than upward." The Court did not decide here either that something less than historical cost could not have been adopted by the commission within the purview of the Constitution. See also *United Fuel and Gas Company vs. Commission*, 278 U. S. 300, 318; *Georgia Railway and Power Co. vs. Railroad Commission*, 262 U. S. 625, 630.

While the District Court, in our case gave effect to its palpably erroneous assumption that the economic conditions and price levels existing when the property was acquired were substantially similar to the economic conditions and price levels existing December 31, 1933, there are some expressions in its opinion indicating that it questioned its own assumption. An example of this is seen in the statement following the discussion of the allowance for accrued depreciation. It there recognizes that the historical cost which it adopts as the measure of the rate base contains prices higher than the prevailing level justified. Judge Chesnut says (I, 557):

> "We are not unmindful that at the present time the depreciation reserve is *slightly higher than normal* and to the extent that it is, it is unfavorable to the Company in the final result as compared with the practice in earlier Commission cases of deducting a flat 20% irrespective of the actual reserve, which was expected, however, on the average to be just

20%. But this disadvantage to the Company is, we think, offset *by allowing it the full of its actual costs despite the generally lower trend of prices.*" (Italics ours.)

The infirmity of that observation is, however, that a reduction in the accrued depreciation to 20% would give effect to the "generally lower trend of prices" only to a slight extent, because the depreciation reserve was only 2.96% above normal as of December 31, 1933. The offsetting effect in dollars would be only $1,480,748 (2.96% of $50,025,278).

But, in the words of the Chief Justice in the *Los Angeles Case*, "In determining the weight to be ascribed in the instant case to historical cost as shown by the evidence, the outstanding fact is that the development of the property had, for the most part, taken place in a recent period." It was uncontradicted that up to 90% (I, 391-393) of the Company's property had been acquired and put into service during the period of high prices after 1917. Thus if the cost of fixed capital on the books on June 30, 1917, amounting to $14,500,000, is simply deducted from the cost of fixed capital on the books December 31, 1932 of $49,000,000, a figure of $34,500,000 results. This difference alone shows that 70% of the cost of total fixed capital as of December 31, 1932 was necessarily installed in that period (I, 391). But that tells only part of the story. Fixed capital costing $20,819,921 was retired from service during the period alone from 1924 to 1932 inclusive (II, 838). While some of those retirements may have covered property acquired by the Company after 1917, the evidence conclusively established that a substantial part of these retirements, plus the retirements from 1918 to 1923 inclusive, applied to fixed capital which was in service as of 1917. It was admitted of course by the Chief Auditor of the Commission that only certain items of property, such as land and buildings, are sus-

ceptible of exact identification as to dates of acquisition and retirement. But according to detailed studies and computations on the subject which he made (and the purport of those studies was uncontradicted), he concluded that *as much as 90% of the entire property existing December 31, 1932 had been acquired and put into service since 1917* (I, 392; II, 839). Thus on the assumption that none of the property in existence on December 31, 1917, was retired during the period beginning on that date and ending on December 31, 1932, we know that 70% of the property owned by the Company as of December 31, 1932, was put into service during the interim. It is of course recognized that much of the property which the Company owned on December 31, 1917, was included in the enormous amount of retirements made after that date. All this evidence was before the District Court, but that Court contents itself with remarking (I, 534):

> "It (*i. e.*, historical cost) represents the actual amount charged to capital on the books of the Company for plant and fixed assets devoted to the public service (after deduction for retirements) during the whole history of the Company which covers a period of 50 years, *although 90%, approximately, of the Company's property has been acquired since* 1910." (Italics ours.)

This rough approximation is arrived at by simply deducting the cost of fixed capital in 1910 from the cost of fixed capital on December 31, 1933, *which assumes that none of the fixed capital in service in* 1910 *has since been retired.*

Mr. Smith's study was made in great detail, by examining each separate account into which the Company's fixed capital is classified, and the only assumption he made in working up the study was a reasonable one (I, 387). But making all due allowance for any slight error which may have crept in because the specific items of

property could not be identified, the conclusion is inescapable that approximately 90% of the property was installed in the high price period and in the first years of the depression.

In view of this uncontradicted and conclusive testimony, and in view of the notoriously sharp decline in the prices of materials and the wages of labor from the period 1917-1920 to December 31, 1933, many times recently judicially noticed by this Court, and conclusively established by the numerous indices of prices put in evidence by the Commission, the District Court's assumption that the historical cost of these properties "represents the actual expenditures for the public service *under conditions reasonably approximating those prevailing at the time of the rate inquiry,*" is, we submit, plainly and simply contrary to the proven facts, and contrary to notorious facts of which judicial notice could be taken.

The circumstances of this case may be compared to the circumstances present in *Reagan vs. Farmers' Loan and Trust Company,* 154 U. S. 362, decided in 1894, and *Smyth vs. Ames,* 169 U. S. 466, decided in 1898, because the present era of low values following a period of higher values is more like those years than any which have since intervened, as the graph at II, 840, shows. In those cases the argument was made and this Court stated that "The construction may have been at a time when materials and labor were at the highest price, so that actual cost far exceeds the present value * * *". (154 U. S. 412.)

The District Court, having made up its mind to historical cost, and although having refused to adopt the Company's method or figures used in its estimate, seeks to get support for the use of historical cost as the rate base by comparing it with the Company's estimate of reproduction value, arbitrarily adjusted to 1929 levels to force a reconciliation (I, 550-551). Thus, for the sake of comparison, it arbitrarily eliminates from the Company's

figures $615,000 of working capital; $1,500,000 in the directly distributed costs of the structural property said to result from the 10.2% increase made after 1929 in Western Electric prices; and $2,005,989 of going value. It also increased the depreciation to be deducted by $4,759,906. By this method of entirely arbitrary adjustment it reduces the Company's figure for depreciated reproduction value to a figure which corresponds with the Court's figure of historical cost plus $1,000,000 of working capital, and from that the Court attempts to reason that "each tends to confirm the other." (I, 551.) We respectfully submit that it does nothing of the kind. Rather, it furnishes an additional test which discredits the use of historical cost as the measure of fair value of these properties in 1934. Since almost all of this property was acquired when costs were at their very highest, it would be surprising if historical cost did *not* agree with an inflated estimate adjusted to the 1929 level; for that is all that the arbitrary adjustments accomplish.

Let us consider not what the Court has eliminated, but what it has *not* eliminated from the Company's appraisal: It has not eliminated that part of the appraisal attributable to 1929 costs, as compared with the costs of labor and materials in the depression years. It has not eliminated, but in this way seems to sanction, the Company's purely conjectural figure of $2,406,587 for hypothetical interest during construction, which may be contrasted with $337,636 actual interest during construction in the properties (I, 601; II, 736). It has not eliminated $2,494,011 out of the figure of $4,500,000 claimed by the Company for going concern value. There was no more reason for adopting $2,494,011 for going value than there was to accept the full $4,500,000. Neither figure was supported by any proof. With these and other amounts left in the Company's figure for reproduction cost value, and

with only the Court's amounts deducted therefrom, the figure is still far higher than reproduction cost "properly found". It follows that the error of using historical cost as the criterion of value is exposed by the analogy which the Court has drawn. If B is clearly too high, and if A equals B, that indicates that A is also too high, not that both A and B are correct. The Company's figure, adjusted only as the Court has adjusted it, is clearly inflated. If historical cost equals that figure, that fact establishes not that "each tends to confirm the other", but that historical cost cannot be adopted.

IX. THE COMPANY'S EVIDENCE OF REPRODUCTION VALUE.

The Company's evidence of value, based on a method of appraisal purporting to show reproduction cost, was founded on hypothetical calculations and was so grossly in excess of the fair and reasonable value, and *a fortiori* the minimum non-confiscatory value, as to deprive it of much of its evidentiary weight and probative force.

While we believe that what has been said heretofore disposes of this case, it is necessary for completeness to analyze in somewhat tedious detail some of the vices inherent in the Company's proof of what is called reproduction cost new.

The Company's estimate of reproduction cost, largely a series of complicated office calculations, resulted in figures so grossly in excess of the fair and reasonable value of its properties that the Commission and the District Court were justified in refusing to follow them. In making its calculations, the Company time and again overshot the mark, vitiating the probative force of its appraisal and rendering it of little or no evidential worth on

the issue of what is the minimum non-confiscatory rate base in the depth of this depression. The *Los Angeles Case, supra;* the *Lindheimer Case, supra; Dayton Power and Light Company vs. Commission, supra; Columbus Gas and Fuel Company vs. Commission, supra.*

The District Court says, in its opinion: "The basis of valuation put forward by the Company is the familiar well known 'reproduction cost new less depreciation' theory of valuation" (I, 535), and "* * * the Company did submit in the hearing before the Commission full data in support of its valuation based on reproduction cost new less depreciation." (I, 558.) If these remarks convey the impression that the Company's evidence was more complete or detailed, or contained more relevant factual data than the exhaustive studies put in evidence by the People's Counsel before the Commission, and put in evidence by the Commission itself before the District Court, they are clearly incorrect and misleading. The representatives of the ratepayers submitted in great detail, relevant data and opinion evidence in the hearing which consumed thirty-six days for the presentation of evidence alone before the Commission (I, 14), and in the Court trial below lasting two weeks. The Commission found as a fact (I, 18):

> "'Both the Company and the Commission realized that to attempt to find the present day fair value of the Company's property by the usual methods of taking an inventory of all items of property owned by the Company and pricing out those items in present day prices, would not only take at least two years of constant work, but would cost the Company not less than $300,000, and cost the State a very substantial sum. *It was agreed that index numbers should be used in arriving at present day costs.*" (Italics ours.)

Neither side, therefore, resorted to the tedious and unnecessary reproduction appraisal method of counting, inventorying and pricing all the specific items of physical property. Both sides assumed that the records of the Company reflected the number of items of property, and from that common premise or starting point reached their widely differing respective estimates of present value of the physical plant. Both sides employed the method of applying index number trends to costs or values determined as of past dates in order to translate them into alleged present-day values (I, 18-19). The respective methods used by the parties, while they differed radically in the index numbers used, in the extent to which the index numbers were applied, and in the figures which were translated into terms of present value, can thus be fairly characterized as "office appraisals" as distinguished from "field appraisals" frequently employed in rate cases. The field appraisal method has demonstrably no advantage from the standpoint of scientific approach and accuracy over the respective methods employed by the parties to this case. The contrary is true (I, 384-385; II, 830). In the exhaustive hearing before the Commission and in the trial before the Court (necessarily to a lesser degree before the Court, because the presentation of evidence there was packed into a hurried hearing of two weeks) all relevant data, estimates and calculations were presented for consideration.

(a) The Company's composite index reveals the exaggeration in the Company's reproduction cost valuation.

In the 1925 District Court case the Company itself had offered in evidence (I, 569) the All Commodities Index of the U. S. Bureau of Labor Statistics, and had also employed a composite telephone construction index, compiled by it-

self, in the same general way that the District Court in that same case applied the All Commodities Index to arrive at a rate base as of December 31, 1923 (including going value and working capital), of $29,507,949 (I, 543). This rate base represented an increase of $7,944,265 above $21,563,684, which was the depreciated historical cost of those properties and which, of course, included all capitalized going value. The gross cost, as of December 31, 1923, was $28,003,479 and the depreciation reserve was $6,439,795 (I, 597). The rate base as determined by the Commission for 1933 was $32,621,190 (I, 76), which was only $7,140,776 less than the depreciated original cost of $39,761,966 as of December 31, 1932 (I, 597). For 1923 the District Court, by the use of the All Commodities Index put in evidence by the Company, increased the depreciated original cost 36.84% to arrive at a rate base, whereas in the case at bar, the Commission decreased the depreciated original cost only 17.96% in order to get a rate base for the year 1933.

The Company's Chief Auditor, in 1925, in a period of rising prices, employed his specially constructed indices in a way comparable to the Commission's use in this case of the All Commodities Index, and about fifteen more standard general indices, and the Court in the 1925 case followed him to the extent of increasing the rate base by that method nearly $8,000,000 above the cost of fixed capital. But the District Court in 1925 would *not* sanction the use there of the Company's specially constructed index, because it gave a result much too high. By the application of that index in 1925 the Company had suggested $37,500,000 as the undepreciated fair value as of December 31, 1923 (I, 217). This was $200,000 higher even than the field appraisal of the Company's witness, Mr. Robinson. The Court in 1925 rejected both of those figures as many millions too high.

But the same specially constructed telephone index, rejected in 1925, and computed in substantially the same way and brought down to December 31, 1932, indicated a reproduction cost new as of December 31, 1932, of approximately $53,000,000 (I, 218). This is so because, as the District Court in the present case found: "This Telephone Company composite trend is shown by the evidence to have been based on the local wage rate paid by the Telephone Company and current prices of the Western Electric Company for telephone apparatus and equipment." (I, 564.) In the hearing before the Commission this index was again in evidence. The Commission's Exhibit D-5 (II, 854A) which also compares this index with the United States Department of Labor Building Materials Index, shows that the undepreciated value as of December 31, 1932, arrived at by the use of the Company's composite index series, would be $52,520,522, and that the undepreciated fair value claimed in the present case by the Company before the Commission was $52,813,618, reached by other methods.

With, therefore, a value of approximately $53,000,000 in mind, the Company realized that it could not employ the All Commodities Index numbers as it had done in 1925, because, if it did so, it would itself be suggesting the figure of $35,427,904 as the *undepreciated* fair value of its properties as of December 31, 1932 (II, 845). It also realized that its specially constructed series of index numbers for telephone construction had been repudiated by the District Court in 1925, and that the wide divergence in direction of that index number series after the year 1929 from all standard indices of commodities and construction costs, would single out for immediate criticism the Company's change of face since 1925. See comparison graphically shown on Exhibit D-5 (II, 872A). The Company's composite index graph coincides almost exactly with the index of the United States Bureau of

Labor Statistics covering Building Materials until 1929. Then the two diverge abruptly (I, 408; II, 854A). During the period of high prices it closely paralleled the index prepared by the Interstate Commerce Commission for telephone construction, but departed radically from it when the depression intervened (I, 421-422).

Therefore the Company did not voluntarily offer in evidence this composite telephone index, but did furnish it at the request of the People's Counsel. The Company adroitly sought to achieve approximately the same result, *i. e.*, an undepreciated value of $52,813,618 (I, 408), by a more complicated and elaborate set of calculations. The result is disclosed in detail in Company's Exhibit A-31 (II, 736-752), with the results for December 31, 1933, shown more briefly in Company's Exhibit A-32 (II, 753-763) which we will fully discuss later.

(b) The Company's appraisal of buildings confirms the applicability of the All Commodities Index as a measure of such values.

The present fair value of the land belonging to the Company, while the subject of vigorous contest before the Commission, was stipulated (in order to save time and expense of proof) to be $589,787 *provided it should become necessary to consider the value of such property separately from the other property of the Company* (I, 96). The miscellaneous small buildings owned by the Company outside of the city of Baltimore were likewise stipulated to have a present fair value of $267,800.

The Company put in evidence detailed estimates of the reproduction cost new, less purely physical depreciation, of the great majority of its principal buildings, most of them located in Baltimore. This estimate was made by Messrs. Frainie and Cummins, the same local builders who had given similar estimates of the reproduction cost

new of substantially the same buildings in the 1925 District Court case. As to their testimony in that case the District Court remarked in 1925 (3 F. (2d) 950):

> "We cannot say that the Commission was wrong in holding that they could not accept the Company's reproduction evidence as conclusive of the value of the buildings, or even highly persuasive within some hundreds of thousands of dollars."

These builders estimated that the reproduction cost new of the buildings they appraised as of December 31, 1932, was $2,391,162 (I, 631). If undistributed costs or overheads are added, the figure is $2,534,631. This is a relatively small figure in the total appraisal, but it is important as illustrative. When it is compared with the estimate which these same witnesses made of the reproduction cost of the same buildings in the 1925 case as of December 31, 1923, a very marked decline is shown. The testimony of these builders in the present case therefore tends to corroborate very substantially the use of general standard index numbers as a measure of the decline in value of the Company's entire property. The Chief Auditor of the Commission, Mr. Smith, made a comparison between the decline in value of these buildings as revealed in the estimates made by these same builders in the two cases, and the decline indicated by the application of the All Commodities Index series (I, 403). This comparison (II, 845), shows that by applying the All Commodities Index translators to these builders' estimates as of 1923 and to the net additions to buildings made in the years since that date, the result is only 2.31% higher than the actual *appraisal* figure given by these builders as of 1932.

But while a comparison of the testimony given by these same builders in the two cases corroborates the decline in cost indicated by the All Commodities Index

numbers when applied to buildings, the ultimate figure of $2,534,631 cannot be accepted as the measure of present fair value, because if the District Court in 1925 was correct in holding that the estimate of these builders in 1923 was "some hundreds of thousands of dollars" too high, the same would appear to be true of their figure for December 31, 1932.

(c) Explanation of the Company's several procedures in valuation.

The rest of the Company's property, and by far the greater portion of it in value and in amount, was appraised by the Company as follows (I, 17-18): its central office equipment, multiple private branch exchange equipment and other station equipment, were appraised by applying to their costs the index numbers developed by the Company itself based on Western Electric prices for materials and installation labor, and the Company's own high labor rates. Its outside plant, such as pole lines, aerial cable, aerial wire, underground conduits and underground and submarine cable, were appraised by pricing out comparatively small samples thereof, and estimating the rest by computations made in the office on the basis of the appraisal of those so-called representative samples. To the so-called directly distributed costs of these properties so computed, the Company's engineers added judgment figures in the form of percentages for overheads, such as contingencies, engineering expense, administration and legal expenses, and large aggregate judgment figures for hypothetical interest, insurance, and taxes during construction. Rights of way were taken at book costs and general equipment and certain minor equipment of central offices were taken at book costs arbitrarily adjusted. In addition, a separate computation for going concern value was made. Accrued physical depreciation

in the properties, expressly limited to such disrepair or deferred maintenance, or deficiency in operating condition as might have been disclosed by inspection if a comprehensive inspection had been made, was also merely estimated on the basis of a physical inspection of a comparatively small sample amounting to 10% of the property. Nothing else was deducted because of age of the property, or because it might have to be replaced in the near future, or as a measure of the loss of value in that part of the property which had exhausted much of its useful service life (I, 273).

(d) The valuation included a large amount of property not used and useful in rendering service, which properly could have been but was not eliminated by the Commission.

As a starting point, the Company assumed that a record inventory kept by its engineers, which had not been completely checked or adjusted by a field count since 1923 (I, 213), correctly listed all of the items of physical property. It excluded from this list nothing whatever except two small parcels of real estate, one a small dwelling in Baltimore, and one a lot at Bethesda, Maryland, which the Company proposed *never* to use in rendering telephone service. The District Court made identically the same assumption, and the Commission did also, except that the Commission *disallowed* the unused real estate located at the corner of St. Paul and Pleasant Streets in Baltimore. With the exceptions noted, Company, Commission and District Court all *assumed* that all of the items of property appearing in the Company record should be included in the rate base, just as though they were all used and useful in rendering telephone service, and just as though they were all entitled to be included in the rate base at their full value, with no deduction for proportionate disuse (I, 116). The evidence clearly

showed, and the Commission found as a fact, that the real property located at the corner of St. Paul and Pleasant Streets had been acquired in 1923 for use as a telephone exchange, but that it had never been used and that there was no definite evidence that it ever would be (I, 72). To borrow the language of the Chief Justice in the *Los Angeles Case*, it "has not been used for several years and is not likely to be used for many years to come, if at all". The District Court substituted its judgment for that of the Commission and restored this non-useful real estate to the rate base (I, 571-572).

But the value of this piece of property is inconsequential compared to the large amount of partially disused plant which the Commission itself generously permitted to remain in the rate base. The whole plant of the Company had been built up to the "boom" requirements of 1929, with a margin of spare and excess equipment adequate for those inflated times (I, 117). Plant had also been provided, years in advance, commensurate with the great hopes for future business, doomed to disappointment by the recession in business activity. Hence practically the entire plant of the Telephone Company on December 31, 1932 and December 31, 1933, while actually in service to *some* extent, was proportionately disused to a great degree. The property in service was not being used to anything like its capacity, and the Commission under the law could well have deducted a substantial amount of it. See *Los Angeles Case, supra; San Diego Land and Town Company vs. Jasper, supra; Darnell vs. Edwards*, 244 U. S. 564. The cost of fixed capital as of December 31, 1928, was $43,288,508 (I, 597), and on December 31, 1933, had been increased by over $6,700,000 (I, 117) to the figure of $50,025,278 (I, 599). But by reason of the falling off of business, the number of the Company's stations in service had declined from

a peak of 221,000 in the year 1931 to 199,127 on December 31, 1933 (I, 111). The number of stations in service on December 31, 1933, corresponded with the number of stations in service on December 31, 1928, which were then 198,426 (I, 611). The graph of connected subscriber stations, put in evidence by the Commission (II, 1088A) shows the story clearly. In other words, for the same number of customers adequately served in 1928, the Company had a greatly increased plant in 1933, costing over $6,700,000 more. Since the customers and their locations change constantly, this figure may not be taken as an absolute measure of excess property. But it certainly indicates *prima facie* that the rate base is inflated by a substantial amount of disused property, and certainly placed upon the Company, which has a peculiar knowledge of the exact facts, the burden of measuring it accurately. To capitalize such excess for present rate making purposes "is to build the rate structure of the business upon assets held in idleness to abide the uses of the future". (*Columbus Gas and Fuel Company vs. Commission, supra,* 406-7.)

The same is true of property being actually used but only to a limited extent. In the *Los Angeles Case* deduction for disuse was only $3,000,000 out of the $10,500,000 cost of certain standby gas manufacturing plants. In *San Diego Land and Town Company vs. Jasper,* 189 U. S. 439, this Court, through Mr. Justice Holmes, disposed of the contention that under certain rates a water company could not earn a 6% return on the total value of its plant, built to serve 6,000 acres, but actually serving very much less, with the following language:

> "If a plant is built, as probably this was, for a larger area *than it finds itself able to supply,* or, apart from that, if it *does not, as yet, have the customers contemplated,* neither justice nor the Constitution requires that, say, two-thirds of the contem-

plated number should pay a full return. The only ground for such a claim is the statute taken strictly according to its letter. * * *

"The statute of California no doubt was contemplating the case of waterworks fully occupied within the area which they intended to supply. It hardly can have meant that a system constructed for six thousand acres should have a full return upon its value from five hundred, if those were all that it supplied. At all events we will not be the first to say so. If necessary to avoid that result we should assume that *only a proportionate part of the system was actually used and useful* within the meaning of the statute." (Italics ours.)

How much more excess plant, because of disuse, was in the Company's records in 1933 in the form of discontinued stations left in service, with their supporting wires, cables, switchboards and central office equipment, also does not clearly appear from the evidence, because the Company failed to offer any evidence to meet in any satisfactory way the burden resting upon it to show that all of its property was fully used and useful. We do know that there were over 20,000 disused stations because there were included in the appraisal for December 31, 1932, 226,826 stations (I, 213), whereas the actual number of stations in use December 31, 1933, was only 199,127 (I, 111). The highest number of stations in service ever reported to the Commission by the Company in its whole history was 221,000 (I, 213, 214).

The Company's Auditor testified (I, 116):

"Our test for excluding property from the capital accounts and putting it into the miscellaneous investment accounts is our conviction that it will *never* be used, and we would keep it in the capital accounts and offer it as a part of our rate base, *even though we were convinced it would not be used within the reasonably near future.*"

And he also later testified (I, 213):

> "We do not take the property out of our books until we definitely know that we are not going to use it, *and that applies no matter how far in the future the use may be.*"

It was clearly shown that this wholly or partially non-used and non-useful property was included on the theory that it represented prudent investment. But it need not be the result of dishonest or obviously wasteful or imprudent expenditures to warrant exclusion. "The public has not underwritten the investment." (*Los Angeles Case, supra*, 306).

As we have seen, the Commission, with the exception of the St. Paul and Pleasant Street property, acquiesced, over the objections of the People's Counsel, in the inclusion of *all* this disused and presently non-useful property (I, 72). Although the Commission could do so under the doctrine of *Banton vs. Belt Line Railway Company*, 268 U. S. 413, 423, its liberality to the Company in this, and in other items, can, on the issue of confiscation at least, be used properly to offset as compensation, or supply a "margin for the correction of other contested items that may approach the border line," if any there be. *Dayton Power and Light Company vs. Commission, supra*, 305. See also *Lincoln Gas Company vs. Lincoln*, 250 U. S. 256; *Los Angeles Case, supra*, 417. It may also be considered by this Court under the doctrine, also enunciated in the *Dayton Case*, that "if the evidence would have been adequate to uphold a lower rate, *a fortiori* it was adequate to uphold the rates prescribed."

(e) The Company's appraisal of physical property discloses a host of arbitrary and erroneous assumptions.

The Company's Exhibit A-31 (II, 738-9) shows the Company's method of estimating reproduction cost of Central Office Equipment and Multiple Private Branch Exchange Equipment as of December 31, 1932. The results arrived at in a similar way for December 31, 1933, are shown in Company's Exhibit A-32 (II, 753-755).

The Company classified its central offices into five groups: (1) large manual common battery, (2) dial, (3) small common battery, (4) magneto or local battery, and (5) toll terminal equipment (I, 196, 214). It then arbitrarily selected one central office in each of the five groups, which it *assumed* to be typical, and appraised those sample central offices for each year from 1923 down to date. On that data alone it worked up its own separate series of index numbers for each of those groups (I, 215). The Company's witnesses then *assumed* that the items entering into the index numbers of all central offices in the same group would be the same as in the index numbers compiled for the so-called typical office of that group. For instance, the Vernon office was selected as typical of the large manual central offices (I, 197); there were twenty offices in that group (I, 224). No particular reason could be advanced for choosing the Vernon office. It was no more typical of the group than any of the others in it. Eighty per cent. of the items in the Vernon office were appraised, and as the Vernon office represented only about 10% of the total cost of all the large manual common battery offices (I, 216), only 8% of the total of those items was appraised. The Company *assumed* that the balance, or 92%, trended exactly in the same way as did the 8% (I, 216). This it assumed in spite of the fact that each central office is tailored to meet the needs of its particular location, and differences

in the proportion of materials entering into the various offices in the group might be considerable (I, 215). The Company's total rebuilding of one central office would be translated by this method into present value by the application of the index number for that year, based on the cost of the comparatively small amount of construction at the Vernon exchange in that year. Nothing was done to correct or allow for these material variations occurring in the different offices and in the different years from 1923 to 1933. The fact that each office was tailored for its own particular location and that the offices were not constructed, rebuilt or altered uniformly during the period from 1923 to 1933, was not recognized in working out these index numbers.

The Company went out of the state to the property of a different company to select the Germantown, Pennsylvania, central office as typical of the group of four dial offices in Maryland. This was done, not because the Germantown office was really typical of the dial offices in Maryland (I, 215) but only because index numbers for the Germantown office had already been made up by the A. T. & T. Furthermore, the cost of the Germantown office was only about 20% of the total cost of the four dial offices of the Company in Maryland (I, 216), and here again the other 80% was *assumed* to change and trend each year in the same degree as the 20%.

For the group of twenty-three small common battery offices, the office at Frederick, Maryland, was selected for study (I, 226). Eighty per cent. of that office was appraised and, since that office represented about 8.3% of all the Company's small common battery offices, only 6.6% of that property of the Company was studied (I, 216), and the balance, amounting to 93.4%, was *assumed* to change in trend each year in the same direction and to the same extent as the small 6.6%.

The Silver Run, Maryland, office supplied the data for the index numbers applied to the 87 magneto or local battery offices of the Company. It represented only about 1% of that property and the 99%, divided among 86 other offices tailored for their own requirements, was *assumed* to vary each year just as the small 1% did. Only 18% of the toll terminal equipment of the Company was used for constructing the indices which the Company applied to that property (I, 216).

We have narrated the above somewhat minutely so that this Court may know that the Company did not undertake to appraise its property in detail.

In these Company studies, Western Electric material prices, Western Electric installation labor costs, and the Company's own high 1930 wage rates furnished the data. Yet, as we shall see, Western Electric Material prices were arbitrarily increased after the year 1929 (I, 234), one increase amounting to as much as 10% on November 1, 1930 (I, 149, 153, 214). A letter from the Company's Chief Engineer Speer to General Manager Irish speaks volumes on this subject. He states that the increases in prices and labor of the Western Electric had amounted to as much as 20% in 1931 alone (I, 235-6). He accepted that increase in cost made by the Western Electric as a matter of course, for he freely revised his estimate and obediently recommended that an additional appropriation be made to cover the increase. In making up the indices, the Company's Chief Engineer said he did not question the Western Electric labor rates. He did, however, take those Western Electric labor rates for the appraisal as of the year 1930 instead of 1932 (I, 228). He stated further that in the appraisal he used the 1930 labor rates of the Telephone Company adjusted for wholesale construction. These Company wage rates had been increased substantially (II, 860B).

We have shown how the indices for Central Office Equipment were involved. The index numbers themselves appearing upon pages 3 and 4 of Company Exhibit A-31 are significant. They show substantial declines between the year 1923 and the year 1932. These indicated declines, however, are delusive. The Company took as its starting point the level of 1923, not actual cost, but the appraisal made for it by one Robinson in the 1925 rate case. But the District Court in 1925 found the Robinson appraisal many millions too high and rejected it. It follows that the decline indicated from the particular year 1923 is misleading.

Attention therefore should be directed to the index numbers for the years 1924 to 1932, inclusive. Upon examination, they reveal the incredible phenomenon that *for only three of those years were costs higher than* 1932; that in the years 1927, 1928, 1929, 1930 and 1931 costs were lower than in 1932. This is notoriously contrary to experience everywhere else in the United States, as this Court many times in recent cases has judicially noticed. Thus in the *Los Angeles Case, supra,* the Chief Justice, speaking of a rate base determined as of December 31, 1930, and referring to the Bulletin of Wholesale Prices, United States Department of Labor, February, 1933, said, at 289 U. S. 308, 311:

> "We have had occasion to take judicial notice of the high level of prices of labor and materials prevailing not only from 1917, as incident to the War, but also in 1922 and 1923 and that there was no 'substantial general decline' in such prices from that time to 1926. • • • But we know that the estimates of present value, as the cost of reproduction as of December 31, 1929, based upon average prices from 1926 or 1927 to 1929, *furnish no dependable criterion of values in the succeeding years.*" (Italics ours.)

To the same effect Mr. Justice Stone, concurring in *West Ohio Gas Company vs. Commission*, decided January 7, 1935, speaking of a value determined as of March 31, 1928, said (55 Sup. Ct. Rep. 316, 323):

> "We judicially know, and cannot ignore, the large declines in price levels and the earnings of capital which have taken place since that date."

See also *Atchison, Topeka and Santa Fe Railway Co. vs. U. S.*, 284 U. S. 248, 260, 262.

It will be observed from the examination of page 3 of Company's Exhibit A-31 (II, 738) that the largest additions to Central Office Equipment from 1924 to 1932, inclusive, were made in 1930, and the Company translated that addition, not by a low translator (the reciprocal of the index number), but by the high translator of 107, so that the Company actually claims the present value of that large addition is 7% more than it cost in 1930. On page 4 of Company Exhibit A-31 (II, 739), we find that the largest additions made to Multiple Private Branch Exchange Equipment were in 1929, yet that addition is trended by the high translator of 112.6 to a present value figure 12.6% higher than its cost in 1929.

The Company claims that there has been eliminated from the computations on pages 3 and 4 of Exhibit A-31 certain amounts for piecemeal construction. The Company's witnesses were hazy about this calculation. They claimed that they ascertained the actual costs of certain properties constructed on a wholesale basis, and compared that cost with a piecemeal construction cost of a somewhat similar project, and having determined the difference between the two, arrived at a judgment figure of 17%; which they deducted from certain items (II, 228-229). The chances of error in such elaborate computations are obviously great; the best that can be said is

that they constitute purely hypothetical and conjectural opinion evidence.

On page 6 of Company's Exhibit A-31 (II, 741), appears the Company's estimate of the present value of Station Equipment. A somewhat different type of index number is compiled by the Company for Station Equipment, beginning in the year 1923 with the high unit costs testified to by Mr. Robinson in the 1925 District Court case (I, 190). The Company, being unable to identify the actual years the Station Equipment was put into service or was retired, attempts in this important exhibit to work out separate index translators for additions and for retirements. In its bookkeeping, additions are recorded at actual cost, whereas retirements are recorded at an *average* cost at date of retirement and not at *original cost* (I, 190-195). Thus, in a drastic period of declining prices the Station Equipment is necessarily retired at a lower cost than its actual cost, because, by averaging the actual cost with the lower cost of succeeding years of declining prices, the figure to be deducted for retirements is decreased. Furthermore, in the appraisal, the retirements are trended by translators lower than the translators applied to the additions *for the same years*. For instance, the additions of 1926 were translated by 91.4%, whereas the retirements of that year were translated at 86.4%; for 1927, the additions were translated at 97.1%, retirements at 86.6%; 1928, additions at 94.6%, retirements at 89.1%; 1929, additions at 97.8%, retirements at 89.4%; 1930, additions at 100.1%, retirements at 90.1%; 1931, additions at 94.9%, retirements at 91.6% (II, 741, columns E and F). Thus the net result of the appraisal is necessarily too high because of the double error of starting with a figure too high, and taking out retirements at an artificially low figure.

Another item on page 6 of Company's Exhibit A-31 (II, 741) merits consideration. In 1927 the Company purchased second-hand telephone instruments from the A. T. & T. at approximately 80% of the 1927 cost of new instruments. The Company, however, does not use the second-hand cost figure as the figure to be translated into the present reproduction cost new of those instruments. It takes instead the 1927 price for *new* instruments and translates *that* price into figures of 1932 (I, 216-217). The Chief Auditor of the Company testified that he did this relying upon the Company's witness, Mr. Sloan, who testified as to the deduction for accrued depreciation, to observe any depreciation in the instruments. The fact remains, however, that the instruments actually cost considerably less than the amount which was trended, and inasmuch as Mr. Sloan inspected not more than 10% of all the Station Equipment of the Company (I, 258), and inasmuch as he gave no weight at all in his inspection to age of the instruments (I, 273, 274), it follows that the Company undoubtedly is claiming an excessive value on those instruments. The above is merely illustrative of the attitude of the Company's appraisers.

Later pages of Company's Exhibit A-31 represent appraisals of Outside Plant (II, 744-750). First of all, it must be recalled that these appraisals are based upon record inventories not checked by complete actual count since 1923 (I, 186, 213). Here also, not all of the items in the accounts were appraised (I, 186). For instance, in the Toll Pole Line Account, only six out of a total of thirty items were appraised. In the Underground and Submarine Cable Account, only seventeen out of 500 items were appraised (I, 189). Out of 1,010 items in all the Outside Plant Accounts only 56 were appraised (I, 189). It is contended by the Company that the items which were appraised were the principal items (I, 186), and the assumption is made that the costs of the so-called

minor items trended and changed each year in the same direction and in exactly the same degree as did the principal items.

After the quantities of the principal items in the Outside Plant Accounts were valued, the labor element in them was appraised, and it was necessary for the Company to *estimate* and add, in the form of percentages, the following items: Exempt Materials, Supply Expense, Plant Supervision Expense, and Tool Expense (I, 198-199). On page 5 of Exhibit A-31 (II, 740) the Company attempts to show that Exempt Materials amounted to 5.5% of the total disbursed material (I, 199). This percentage was arrived at by taking the actual materials disbursed by the Company during the years 1930, 1931 and 1932 and comparing the cost thereof with the cost of Exempt Materials to the Company in those years. The actual percentage so ascertained was 5.61% and the percentage used in the appraisal was 5.5% (I, 222). When we consider that the actual construction done by the Company during the last few years was small piecemeal construction, it becomes apparent that the Exempt Materials on a "single impulse" reproduction theory may vary considerably from the actual experience of the Company in the last three years. The total materials disbursed over the last few years are then equated to December, 1932 prices. The cost of the Supply Expense during the same three years is ascertained, and the ratio of the two is determined to be 3.86% (I, 222), but the figure used in the appraisal is 3%. Here again, there may be no correspondence between the experience of the Company over the last three years, and the cost which would be incurred for supplies in a complete reproduction of the property.

In the computation of Plant Supervision Expense, the Company had to make several additional assumptions. First, it did not have the actual labor cost used in the

appraisal for any of the accounts. It had to take the total labor cost in the appraisal and apportion that labor to the Outside Plant Accounts in the ratio of the total material in the valuation to the material in those various accounts. After the theoretical labor figure is thus obtained, the actual Plant Supervision Expense for the same period is computed, and it is found that the actual expense is 7.8% of the theoretical labor expense (I, 199). This percentage is rounded out to 8% and so used in the appraisal. However, the actual labor in the accounts mentioned appears to be considerably higher than the theoretical labor thus estimated, so that if the actual Plant Supervision be compared to the actual labor, rather than to the theoretical labor expense, a lower percentage of about 6% for this item is obtained (II, 740, lines 7, 8 and 9).

Substantially the same procedure as to Plant Supervision is followed with regard to Tool Expense (I, 199), and if the Tool Expense be related to the actual labor cost rather than to the theoretical estimated labor cost, a lower percentage is likewise obtained. After the direct costs have been obtained and after the Exempt Materials and Supply Expense and Plant Supervision and Tool Expense have been calculated, the Company arrived at a total cost in place of the principal items. It was then necessary to arrive at the value of the much larger number of other items not appraised. That was done in this way: The Company appraised its so-called principal items as of December 31, 1932, at the high 1923 unit costs supplied by Mr. Robinson in the 1925 case (I, 189), and it also appraised the other items in existence on December 31, 1932, at the Robinson 1923 unit costs. It thus values all of the units of outside plant owned on December 31, 1932, in terms of the high unit costs as of 1923 supplied by Mr. Robinson. It then determined the relationship between the values thus shown of the principal items

and the values of the other items, and it assumes that the same relationship between the principal items and the other items, all appraised at 1923 Robinson unit costs, continues all the way down to the year 1932.

(f) The value claimed by the Company was based, at least in part, on the unreasonably high prices for material charged by the Western Electric Company.

In the above analysis of the calculations made in the Company's appraisal, we have alluded frequently to the fact that Western Electric catalogue prices for materials were employed. The Chief Auditor of the Company testified:

> "Referring to Exhibit A-31, which is the estimated reproduction cost new, the value of that estimate would depend in the last analysis on the prices we used for materials as of the appraisal date. We have used in this appraisal Western Electric catalogue prices, both for the items they manufacture and the items they do not manufacture, without any allowance for the decline in the materials and in the labor that go into those articles. • • • The prices which we have used as of December 31, 1932 are the Western Electric prices and include any increase in prices made by the Western Electric Company since the depression." (I, 214.)

It therefore becomes necessary to examine the factor of Western Electric prices in detail.

That Company, so large that it has an investment in plant of about $160,000,000 (I, 182), is a 98% owned subsidiary of the A. T. & T., and it performs two functions for the Bell Companies: first, it manufactures telephone apparatus and equipment, and second, it acts as a purchasing agent for the Bell Companies. About 95% of its sales are to the A. T. & T. group (I, 138). About 90% of the purchases by the Telephone Company are made from the Western Electric (I, 166-7).

The vital importance of the Western Electric is thus apparent. It is in a position of immense power. Unless the effect of its dealings with its sister companies is recognized and limited, it has the power utterly to defeat telephone rate regulation. It enjoys complete price fixing power. For illustration, it may be noted that with its volume in 1933 down to 16% of its 1929 output (I, 438), it actually increased its prices 10.2% in November, 1930, in order to pass on to telephone ratepayers some of the enormous carrying charges of its greatly overbuilt plant (I, 153). At least 25% of the Company's appraisal was directly raised by these price increases (I, 423). Its prices were again increased as of January 1, 1934, which the Company claims would *ipso facto* and without more, overnight, automatically raise the *value* of its properties in 1934, $1,400,000 over their value in 1933 (I, 234, 382), Exhibit A-44, (II, 798). In explanation of these increases in prices, Mr. Crosland, the Auditor of Western Electric, testified:

> "The reason we had to make the increase in prices in 1930 * * * was that we were not getting the business. And the reason for that is if we did not get the business and we have those facilities, it is costing us more to carry on, and that is the reason we made the increase." (I, 156-157.)

What is more, these increases in prices to the Bell Companies were in spite of the fact that the cost of materials to the Western Electric Company in 1932 was down 34% from their cost in 1929 (I, 155, 405). This decline may be compared to the decline of 32% in the All Commodities Index (I, 405). The prices which it charged the Bell Companies for equipment were increased when almost all other prices were drastically going down. Mr. Cox, testifying for the Company, claimed that Western Electric prices are modest when others are high "and when times are bad and everybody else's prices are low

that the Western Electric Company's prices are higher." (I, 516.) (See discussion pages 127-131).

The Western Electric is able to make these increases at will and does so because it has substantially a complete monopoly of the business and is operating in a non-competitive market (I, 181, 182). The A. T. & T. affords a perfect illustration of both a vertical and a horizontal monopoly. The Company's witness Mr. Crosland testified; "I do not know that there is any market price for apparatus and equipment." (I, 157.) There is nothing to prevent Western Electric from raising its prices at any time except the self-control of its parent, the A. T. & T., which cannot be expected to protest an action which benefits the Western Electric and, at the same time, affords an argument for higher valuations of the properties of its operating companies. It goes without saying, we submit, that the price increases in 1930 and 1934 must be ignored in arriving at a figure of fair value for the Company. See *Illinois Bell Telephone Company vs. Gilbert*, 3 F. Supp. 595. These subjective and wholly potestative increases certainly cannot be accepted as having any bearing whatever upon value. But the District Court, although it is willing to eliminate the effect of these increases, utterly ignores the fact that in order to be any criterion of present value, these Western Electric prices must obey general economic laws *and decline substantially* instead of increase substantially during the depression years.

The District Court, in its opinion, states (I, 567):

> "With relation to valuation based on historical book costs, counsel for the Commission do not attack the reasonableness of prices which the Company has in the past paid for its telephone material . . . And indeed the only specific complaint made by the Commission about Western Electric prices is that the Company's estimate of reproduction cost is based on the *present prices* of Western Electric which include

a raise in prices of about 10% effective November 1, 1930."

It is respectfully submitted that in saying this the District Court misses the real point altogether. It is true that the Commission, in order to arrive at fair value, was forced to apply its index translaters to the Company's cost figures, including prices paid in the past to the Western Electric for materials and installation labor, but to *that extent only* it perforce accepted the Western Electric prices charged in the past. It never conceded for a moment that these were not at all times subjective, potestative, monopoly prices. In order for them to indicate present fair value of the Company's property in 1932-1933, however, the Commission felt that they *must* necessarily be translated, not merely to the 1929 level, but to the lower levels *after* 1929 to accord with universal experience. It may be true, as the Company's Engineer Speer testified, that if merely the increase in Western Electric prices made in 1930 is eliminated in his calculations, a reduction of only $1,500,000 will result (I, 234). The mere elimination of this increase, however, without more, would leave Western Electric prices *at the level of 1929* as the measure of value for the Company's properties at the end of 1933 which, we submit, is unthinkable. *Not only must the increase said to amount to $1,500,000 be eliminated, but many more millions must be eliminated in order to arrive at any indication of present fair value.*

The District Court says: "* * * no figures have been submitted in evidence as a basis for any deduction from historical book cost on this account". (I, 567.) In saying this the District Court ignores the mass of evidence in the form of index numbers and otherwise (if, in view of the doctrine of proper judicial notice, any evidence of it is needed), all to the effect that prices generally have declined drastically. The cost of materials to the Western

Electric itself had declined 34% in 1932 from their cost in 1929 (I, 155, 425).

Through its witness Mr. Cox, the Company filed in evidence a series of index numbers compiled from Western Electric prices. This index number series appears in Exhibits A-50, A-51 and A-52 (II, 804-806). The index numbers of course include the increase in prices, discussed above, which was arbitrarily put into effect in 1930. The Company filed similar Western Electric price index numbers in the case before the Commission, and the Commission, in arriving at fair value, considered this Western Electric index along with many standard general indices, giving it a weight, after simply eliminating the price increases after 1929, of three in a total weight of thirty-one (I, 38). That index, eliminating of course the increases after 1929, applied to the value determined by the District Court in 1925 and to the net additions to the plant since that time, would have indicated a value without working capital on December 31, 1932, of $34,567,633 (II, 868-869). It is interesting to note, however, that if the Western Electric prices had been permitted to follow economic laws to the extent of showing a decrease of only 10% *after* 1929, instead of the *increases* made after that date, the resultant fair value would have been, including working capital, approximately $32,000,000 (I, 423). It is submitted that the Commission and the District Court had ample evidence before them in the form of standard index number trends, and in other forms, to justify the conclusion that if Western Electric prices are to be used for *value*, they must be reduced *at least* 10% from their 1929 level. This figure of $32,000,000 should be compared with the fair value found by the Commission of $32,621,190 for 1933 (I, 76). This comparison is highly significant.

The Company contends that the advances in Western Electric prices in 1930 and subsequent years were justi-

fied because its prices were comparatively low in the years preceding 1930. It attempted to show in great detail that the trend of Western Electric prices was under the trend of the All Commodities Index, and that therefore the Company was justified in advancing its prices when the All Commodities trend showed a substantial decline. But the contention is not supported by the facts. Company Exhibit A-50 (II, 804) is a graph comparing the trend of Western Electric prices with the All Commodities Index trend. It there will be seen that from 1921 to 1934 the Western Electric's total index (shown in green) was substantially higher than the All Commodities Index in all except approximately two and a half years, 1927 to 1930. The Company's contention, therefore, that for any substantial period before 1930 the Western Electric price trend is generally lower than the All Commodities price trend is directly contradicted by its own exhibit (II, 804).

Again the Company, in Exhibits A-51 and A-52 (II, 805-806) attempts to show that Western Electric prices were substantially below the level of the All Commodities Index for the years 1921 to 1934, respectively, but Exhibits A-51 and A-52 do not correctly portray the facts. The effect they give results solely from tying together the various index numbers in 1921 and in 1923. The comparison must be considered in connection with the testimony of the Company's Chief Auditor that there was *no difference in experience between the composite telephone index he compiled and general commodity prices*, except that the telephone index showed a "perceptible lag" (I, 2[illegible]). Exhibit A-50 shows that for the years 1921 to 1923 the Western Electric index ranged at substantially higher levels than the All Commodities Index, so that if those indices are tied together in 1921, 1922, or 1923, it will of course appear that the Western Electric prices descended more rapidly than the All Commodities

Index in the period subsequent to the year in which the indices are arbitrarily tied together. The very opposite result, however, would be shown if the indices were tied together in 1920, for in that year the All Commodities Index was substantially higher than the indices of the Western Electric Company. If the indices were tied together in the year 1920, the All Commodities Index for the years thereafter would have shown a tremendous decline, whereas the Western Electric index number trend would have shown a relatively small decline.

Thus the "lag" testified to by the Company's Chief Auditor is important, but that lag has been used by the Company in Exhibits A-51 and A-52 to give a distorted comparison. It was proper to chain the index numbers together in 1914, because the year 1914 and the years immediately prior thereto were what might be called normal years, if the term normal can be applied to any period. Certainly 1914 was a much better starting point for comparison than the war years or the years immediately thereafter.

Heretofore we have alluded to the composite telephone construction index compiled by the Company, which indicated an undepreciated value of $52,520,522 as of December 31, 1932. In connection with this index also the Company made the claim that during the years 1914 to 1923 it never went higher than the All Commodities Index number, and that that fact should excuse its tendency to rise after 1929 when the All Commodities Index was declining. The Company's Chief Auditor Gretz testified as follows:

> "As to whether the special telephone costs travelled along with the general commodities or not, I am going to introduce later some curves or charts to show the trend over the period from 1914 to 1932. Speaking of the period 1914 to 1923, the point is that telephone construction costs never did get anywhere near as high as the commodity index. The all

commodity trend had taken a curve that had gone up to a great big peak and then came down. While the telephone construction curve went along on a slower curve, it was never as high as the curve of the commodities trend, it did not go up to the top peak of that trend nor did it have the same amount of reduction." (I, 219.)

If the witness was claiming that at all times the telephone construction costs as disclosed by the Company's composite index were under the level of All Commodities prices related to 1914 as a base, he is clearly wrong, as reference to the chart alluded to by him discloses (II, 801). The lower section of the chart on that page shows that the telephone index was lower than the All Commodities Index from some time in 1915 to some time in 1920. After 1920, however, the telephone index never in any single year got as low as the All Commodities Index. During the war years the telephone companies were taken over by the Government and normal expansion of the telephone companies was curtailed, and it is perhaps due in a measure to this fact that telephone prices did not go as high as the All Commodities prices for the years 1915 to 1920. The telephone index did rise, however, during and immediately after the war years, and it rose to a figure higher than the All Commodities Index in 1921; but unlike the All Commodities Index, it has never come down.

The chart mentioned indicates that the telephone index has declined but a few points since 1923, even though during the whole of the time since 1923 it has been higher than the All Commodities Index. There appears to have been about a two-year lag between the telephone index and the All Commodities Index when prices were going up, but there appears to be more than a five-year lag now, because the telephone index has not yet begun to decline in obedience to the impulse which re-

quired the decline in the All Commodities Index beginning in 1929. In fact, there is a remarkable correlation between the Telephone Company composite index and the All Commodities Index for the years 1923 to 1929, inclusive (II, 801). Thus the Company's telephone composite index does not even show the decline which the graph of the Western Electric prices showed in the short period of two and a half years from 1927 to 1930 (II, 804).

The Company sought to justify Western Electric prices by many exhibits which may be classified into two groups: (1) those intended to show that the Western Electric prices were lower than the prices of similar articles sold by its so-called competitors; and (2), those intended to show that the Western Electric made only a reasonable profit from its operations. This evidence will be discussed in the order mentioned.

It is futile to attempt to justify prices charged the Company by the Western Electric for materials and supplies by comparing those prices with the prices charged the general trade by such concerns as Kellogg Switchboard and Supply Company; Automatic Electric Company; the American Electric Company; and the Stromberg Carlson Telephone Manufacturing Company; yet this is what the Company attempts to do through Mr. Cox (I, 168). Admittedly these concerns are tiny in size of investment and in business done, as compared with the Western Electric, which has an investment in plant of over $160,000,000 (I, 182), and has done as much as $150,000,000 worth of business a year with the Bell Companies alone (I, 145). Some of these so-called competitors are too small to be listed in Moody's Manual (I, 455).

With the exception of the business of manufacturing and selling lead-covered cable, the Western Electric has no real competitors. They are competitors in name only

(I, 413), and Mr. Cox freely admitted that the Western Electric Company could undersell and put out of business any independent telephone supply company in the country *if that were "ethical"* (I, 181-182).

While the Bell Companies have a nominal right to purchase their supplies from sources other than the Western Electric Company, in practice they cannot do so, because in the first place the A. T. & T. recommends that the Bell Companies place orders with Western Electric (I, 164), and in the second place, as Mr. Cox also admitted, if an initial investment is once made in complicated central office equipment constructed by the Western Electric under its patents, necessarily the Telephone Company "would be forced to deal with the Western Electric from then on with respect to facilities necessary to use that initial investment." (I, 180.)

The attempt to segregate the cost of the Western Electric's business with the Bell Companies from the cost of its non-Bell business fails completely, for the reason that the Western Electric has no adequate cost system. Mr. Crosland testified that the Western Electric cannot tell the costs of any articles it manufactures (I, 153). On the other hand, it maintains a system of cost accounting to which it misapplies the term standard cost system. It is recognized, of course, that a true standard cost system may be of great value if kept in detail and up to date and if the standards are frequently revised; and if, in addition, actual costs are likewise recorded. Such a system permits the management of a manufacturing concern to analyze its operations and to determine quickly the current estimated or standard costs as compared with the actual costs of the various factors entering into the finished product. See E. A. Camman, *Basic Standard Costs*, G. C. Harrison, *Standard Costs*, Charles Reitell, *Cost Accounting*. But it was testified that the Western Electric Company maintains no such cost system. And

as stated before, it does not attempt to determine and record actual costs of its various products (I, 153, 433, 434).

But equally serious is the fact that the Western Electric does not revise its standards to make them reflect current conditions. It admits that it has not changed its standards since January 1, 1930. As testified by Mr. Crosland: "We have not made any changes in them since that time, although there have been revolutionary price and cost changes". For instance, there was a decrease of 34% in the actual cost of material as compared with the standard (I, 155). But in attempting to compute its cost, the Western Electric used the standards which were fixed in 1929, and therefore gave no recognition whatever to the 34% decrease in the cost of materials (I, 155). How can a system employing standards established in 1929 be of any practical value for the Company's purpose in this case? While it is true that there was only a three to four year interim between 1929, when these standards were fixed, and 1933, when they were still being applied, the change in economic conditions during that period was so great that the interim might for all practical purposes have been of one hundred years duration. The actual production of Western Electric had declined in 1933 to 16% of its 1929 volume, and yet the same standards—volumes—quantities—prices—are employed for both years.

Company Exhibits A-17 and A-18, filed in evidence by Mr. Crosland, compare the alleged Western Electric profits on the Bell business alone, with profits of other concerns (II, 661-663). In contradistinction to this attempt on the part of the Company to indicate the profits made by the Western Electric solely on its Bell business, studies made by the Chief Auditor of the Commission disclose the enormous profits derived by the Western Electric for a period of years upon its entire business. Profits

upon the Western Electric's entire business are compared with the profits of other concerns in Commission's Exhibit D-8 (II, 877-880).

The Company's exhibits purport to show that during the years 1916 to 1932, inclusive, the Western Electric Company enjoyed but a 5.8% return on its Bell business, whereas the selected 88 companies enjoyed an average return of 9.3% during the years 1925 to 1932. The corporations chosen by the Company for comparison are, in the first place, evidently hand-picked. They include tobacco companies, drug companies, and specialty companies, which had notoriously high returns. Mr. Crosland admitted that the electrical manufacturing companies were more nearly comparable with Western Electric, saying (I, 158):

> "I believe that the electrical manufacturing companies on the list, such as the General Electric and the Westinghouse, are more nearly comparable with the Western Electric. The Westinghouse Company, number 85 on the list, shows roughly about 5%."

In weighing the value of this comparison, two important points must be kept in sight. In the first place, the return of Western Electric is computed for the years 1916 to 1932 (II, 861), whereas the returns of the 88 companies are computed only for the period 1925 to 1932. The return of the Western Electric figured on any basis is higher for the years 1925 to 1932 than for the period 1916 to 1925. The return of Western Electric for the period 1925 to 1932, computed as on Exhibit A-17, is 6.03%. Furthermore, the earnings of the 88 companies include their total income, operating income as well as non-operating income, whereas the income of Western Electric with which they are compared, includes only an estimated part of its entire operating income claimed by the Company to be assignable to the large Bell business, and none of its non-operating income. The non-

operating and special income of the Western Electric Company was enormous during the period 1925 to 1932, amounting to about $23,000,000 (II, 879).

The Commission studies appearing in Exhibit D-8 (II, 877-880) indicate that the Western Electric enjoyed most profitable earnings during the years 1924 to 1932. The study shown at II, 877, compares the earnings of the Western Electric Company with the earnings of *all* the companies reported in the Standard Statistics analysis. Here the figures for all companies are on exactly the same basis. They show that the Western Electric Company had an average return on plant of 13.29% during the years 1927 to 1932, after the exclusion of $9,938,000 representing special income, when all the other corporations studied had an average annual return of 10.78%.

A tabulation of the respective earnings each year is given below:

Year	*Western Electric*	*Leading Industrials*
1927	29.42%	13.7%
1928	32.54%	16.9%
1929	23.87%	17.6%
1930	12.38%	9.9%
1931	9.38%	4.2%
1932	(5.81%)*	1.1%

*Parentheses indicate loss.

One of the differences between Company Exhibit A-17 and the Commission's Exhibit D-8, as shown at II, 877, is that in the Commission's exhibit the depreciation expense was deducted from earnings, and the depreciation reserve was deducted from the property and investments for all companies, whereas in the Company Exhibit A-17 depreciation expense was allowed as an expense, but the reserve was not deducted from the property and investments. It is obvious that a proper comparison requires

the deduction of the reserve, because, inasmuch as the depreciation expense is not uniform for all companies, in no other way could the companies be placed upon a comparable basis as to rate of earnings.

The Company also offered in evidence Exhibit A-19 (II, 664), comparing the relationship of Western Electric profits to sales with some 38 manufacturing corporations. Such a comparison is obviously worthless, since the margin of profits per sale fluctuates violently, not only among different industries, but also between business institutions reaping equal percentage of returns on investment within the same industry. The relation of profit to number of sales may of course be very low, and yet the return realized on the investment very high indeed. It is notorious that the profit per sale in the jewelry trade is very high, whereas the profit per sale in the bread industry is very low. The average profit on sales of the 38 companies shown in Exhibit A-19 is 10.1%. The profit realized by the Telephone Company on its sales in the year 1932, according to its own computation, was 21% (I, 611). A study of the relationship of profits to sales without a corresponding study of the relationship of sales to capital turnover is of no value whatsoever.

In Commission's Exhibit D-8 (II, 878, 879), there appears a study comparing the return on capital stocks and surpluses of electrical manufacturing corporations with the return of Western Electric during the years 1924 to 1932. This comparison should be particularly important in view of the fact admitted by Mr. Crosland (I, 158) that electrical manufacturing companies are more nearly comparable with the Western Electric. The electrical corporations listed were taken from a summary page of Moody's Manual of Industrials. Three companies are omitted only because, as to them, the necessary information was not available (I, 439-440).

This exhibit indicates that for 137 "corporation-years" Western Electric had higher earnings, and that it had lower earnings in only 82 "corporation-years". It shows further that the Western Electric enjoyed higher earnings than the majority of the corporations in each of the years listed, with the exception of the year 1932. Mr. Cox compared Western Electric prices with the prices charged by the so-called small competitors, including General Cable Corporation and Kellogg Switchboard and Supply Company (I, 168, 175). It is significant that for each of the years listed for the General Cable Corporation, it had a lower rate of return than that enjoyed by the Western Electric, and it is also significant that in only one of the years listed, namely, 1924, did the Kellogg Switchboard and Supply Company enjoy a higher rate of return than that shown for the Western Electric (II, 878, 879).

If further evidence be needed that the Western Electric Company has made enormous profits, which should be taken into account in considering the reasonableness of the prices which it charged to the Company, that evidence may be supplied by a study of the dividends which it has been able to pay to the A. T. & T. Commission's Exhibit D-8 (II, 880) shows that the A. T. & T. received an average of yearly dividends amounting to 16.93% on its investment in Western Electric during the years 1924 to 1932. Mr. Crosland, the witness who assumed the burden of attacking Exhibit D-8, stated that the large dividend paid by the Western Electric in 1927 was a dividend paid from earnings on non-Bell business accumulated from 1881 to 1927. It was plainly the intention of the Company and Mr. Crosland to lead the District Court to believe that of the dividends paid during the years 1924 to 1932, some $48,000,000 represented earnings which were made prior to 1924 and from activities not associated with the Company's Bell business (I, 519).

This claim, however, is easily refuted, in the exhibit shown at II, 880. This exhibit shows that the $140,000,000 of dividends were paid to the A. T. & T. *without impairing the surplus of Western Electric as of December* 31, 1923; in fact, the surplus increased some $5,000,000 during the period 1924 to 1932, in spite of the payment of the dividends. It must be true that any earnings of the non-Bell business in 1881 were either in the surplus account as of 1923, or else disbursed as dividends prior to that time. So thus it is shown beyond all doubt that the earnings during the period 1924-1932 amounted to at least as much as the dividends paid during that time. When the increase in the surplus of some five million dollars is also taken into account, it is shown that the A. T. & T. received an average annual return for the years 1924 to 1932 on its investment in the Western Electric Company of 17.59%.

(g) The "undistributed construction costs" included in the Company's value were conjectural, uncertain, based on no specific or substantial evidence, and were greatly in excess of the actual cost of such overheads in the existing plant of the Company.

After making its estimate of so-called directly distributed construction costs of its structural properties, the Company's engineers added to it, in the form of percentages and theoretical computations, large amounts for undistributed construction costs and overheads as of 1932. These include (1) Contingencies, (2) Engineering, (3) Administration, Legal Expenses and Insurance, (4) Taxes and (5) Interest during Construction. They represent a total in the appraisal of $7,206,562, which amounts to 18.56% of the Company's inflated figure for directly distributed costs of $38,806,154. When going concern value is added the overheads are $11,856,562 or 30.55%

of the directly distributed costs (II, 736. Comparable figures for 1933 are shown at II, 753).

The total interest during construction on the books of the Company as of December 31, 1932, amounted to $337,636 (I, 601). This actual payment is the only interest during construction which should be valued. Nevertheless, the Company, by elaborate hypothetical computations, made by its witness, Mr. Sloan, in the reproduction cost estimate, turns its back upon its own actual experience and gives a figure of interest amounting to $2,406,587 (I, 736). *This figure is over 600% higher than the only interest during construction that was ever paid by this Company and capitalized during the whole of its history.* Mr. Sloan made hypothetical computations of the periods when construction charges would be incurred and when exchanges would be cut into service, and by computing interest on the construction expenditures to the time the respective properties would be cut into service, he arrived at the suppositious figure mentioned above. This sort of evidence is simply fantastic.

Nowhere in his testimony did Mr. Sloan identify any exchanges which he supposed would be cut into service on particular dates, although he naively testified as to the cost and dates of the exchanges which would be cut into service. Every figure which he set down with purported mathematical precision is delusive in the extreme. He may be charitably compared with the experts of whom Mr. Justice Cardozo, in the *Columbus Gas Case* remarked that their opinions appear to be derived "very little from any knowledge of the 'history and circumstances of the particular enterprise'."

The problem of interest and other undistributed overheads is simple. It consists of valuing at present prices the quantity of interest actually present in the properties, in the same manner as we value the amount of labor and material which are there. If those actualities are

ascertainable, as in this case, from the accurate cost records of the Company, it does violence to ordinary common sense to go afield and compute by elaborate suppositions, what might be expended under circumstances which no sane person contemplates.

The item of contingencies, that is, errors, omissions, etc., in engineering judgment, discloses this conjecture at its *reductio ad absurdum*. The Company asks the Commission to allow to it as rate base, the cost of mistakes not made from 1884 to 1933, but which *might be made* if the plant were now hypothetically rebuilt.

All of these undistributed overheads have been valued by the Commission in trending the historical cost of the plant, to the extent that the investors' money has gone into that cost as capital; or have been paid for long since by telephone users in operating expenses. This hypothetical computation of overheads and intangibles is the factor more than any other which has made a mockery of the reproduction cost theory. Was it a flagrant defiance of the Constitution for the Commission to refuse to be bound by evidence such as this?

(h) The cost of labor used in the Company's appraisal was greatly in excess of its market value.

It was admitted by the Company that 29% of the total cost of its properties represents the cost of Telephone Company labor, and that 4% represents the cost of installation labor paid by the Company to the Western Electric (I, 423). The Chief Auditor of the Commission made a detailed study of the Company's construction costs incurred in the years 1924 to 1932 and ascertained from that study that 54.99% represented the cost of materials and 35.01% represented the cost of labor in those additions (I, 478; II, 861-2). It may be assumed, therefore, that of the total costs of fixed capital, roughly

65% is materials and 35% is labor. We have previously discussed the way in which the Company valued the material element. In this section we propose to show that the labor element in the properties was also greatly overvalued.

It appears that in its estimate the Company used as the cost of labor performed by its own employes its wage rate paid in the year 1930. In a note to the District Court's opinion (I, 549), it is said:

> "In the cost of reproduction the assumed wage rate is the Company's present current wage rate (now somewhat higher than in the past) but adjusted downward for wholesale or large construction work, according to the testimony of the Company's chief engineer, Speer."

Counsel for the Commission, however, admit that Mr. Speer actually employed the Company's 1930 wage rates, which were lower than those paid in 1932.

The chart at II, 860B, is a graphic illustration of the steady rise of the Company's hourly wage rate without abatement, and discloses a comparison of its trend with the trend of actual wage rates paid generally in Baltimore. But as a criterion of the value of the element ascribable to labor, it is submitted that the elimination of increase by choosing 1930 labor rates did not go far enough. Even in 1930 the Company's average wage rate was higher than it had been paying in former years. The District Court correctly finds (I, 548) that "The uncontradicted evidence is that the Telephone Company's wage rate has been rising rather than falling."

To determine the cost of the installation labor element supplied by the Western Electric, amounting to 4% of the total cost of the Company's properties (I, 423), the Company in its appraisal took the amounts paid Western Electric in 1930 (I, 228). By this expedient it eliminated from the final result the effect of a 10% reduction made

in 1933 in the wages paid by the Western Electric to its employes (I, 153).

The District Court says that the Company is subject to no valid criticism for maintaining its wage scale (I, 549, Note). To this it is sufficient to say that the Commission has not attempted to criticise the policy of the Company's internal management in paying its employes high wages even during the depression. In the historical cost figures which the Commission has translated into terms of present value, such liberal wages are expressly reflected, and the Commission made no deduction from allowable operating expenses because of these high rates. At the same time, it is one thing to refrain from criticizing the Company's policy of internal management, and quite another thing to accept such increases in wage rates made by this Company as convincing evidence of the value of its properties as of the end of 1932 or 1933. The Company's private high wage scale simply cannot, on the issue of confiscation, be given the latter effect, because it does not represent the objective value of labor.

This is conclusively demonstrated by an elaborate study personally made by the Commission's Chief Auditor, Mr. Smith. Over a long period of time he personally interviewed large employers of labor throughout Baltimore and inspected their records to ascertain the actual labor rates which they paid to various types of workers in the building trades each year from 1923 to 1933, inclusive. The results of his investigations are shown in a table at II, 860, and from this study he compiled a series of index numbers reflecting the decline in the market value of labor. Mr. Smith testified that in making up this table he expressly did not select distress wages, even though paid in some instances. He said: "During the years 1923 to 1931, I did not take the highest wage which I found, nor in the year 1933 did I take the lowest. For instance,

I found in 1933 carpenters generally were getting 40 cents an hour. I show here 55 cents an hour." (I, 414-5.) The Commission gave this index a weight of 1½ out of a total weight of 31 in arriving at its fair value trend (I, 38). The labor wage trend was extremely important because so many of the general indices employed by the Commission did not include the element of installation labor. Nor did the District Court in 1925 have information about labor rates. It may be noted that the wage trend developed by Mr. Smith told approximately the same story of the decline in labor costs as the wage trends of the Engineering News Record for skilled and common labor (II, 860A). From the table so compiled by Mr. Smith (II, 860) it will be seen that the simple mathematical average hourly wage rate of all these workers declined from $1.268 in 1929 to $.717 in 1933. This evidence was uncontradicted. In the face of this conclusive evidence can it possibly be said that the Company's own individual experience, so contrary to universal experience elsewhere, is evidence of present fair value "too strong to be rejected"?

The District Court, erroneously we contend, sanctioned the use of the Company's own high wage rate in making up its estimate of reproduction cost (I, 564). But it is apparent from the footnote to its opinion (I, 549), that this element among others influenced the Court to reject the Company's estimate of reproduction cost new as the measure of value, and to adopt historical cost instead, because the Court, after discussing the high wage rates employed in the appraisal, there said:

> "This illustrates the view that the cost of reproduction is, inherently a method of valuation less satisfactory than historical cost in this case."

In adopting historical cost as the measure of value, the

District Court seems to have been influenced by a claim made by the Company that its wage rates had been lower in the past than the general labor rate paid in Baltimore. In another note to the Court's opinion (I, 549) the Court observed:

> "It should also be noted that the wage rate paid by the Telephone Company in the last ten years has been generally lower than the average Baltimore wage rate as determined by the Commission. On the basis of valuation by book or historical cost the public has obtained the advantage of this in the construction costs charged to capital on the books of the Company. (See Plaintiff's Ex. A-46)."

The reference to Company's Exhibit A-46 (II, 800) gives the key to the Court's error in this regard. On that exhibit, by a series of graphs, the Company attempted to compare the *absolute* wages in dollars used by the Commission's Chief Auditor in his study of the trend of general wage rates paid in Baltimore, with the average wages paid in dollars by the Company to its own employes over the same period of years. It shows that the simple mathematical average of the hourly wages paid the types of laborers selected for study was higher than the simple mathematical average of the telephone wage rates paid in dollars. Such a comparison is misleading. The Chief Auditor of the Commission made the study in order to ascertain the *trend* of general wage rates and was not interested in the absolute figure in dollars. As to this he testified (I, 415):

> "I was anxious to ascertain what was the labor trend during this period. I was not trying to find an absolute average hourly rate of wage. And that is what Mr. Gretz apparently thought I was doing. That is wrong, because the average hourly rate would not be anything like I have here. We have too many bricklayers and so forth. . . . You would have a very

large proportion of common labor in constructing a telephone line. Here again the trend of the curve is the important thing and not the space between the two curves."

(i) The element of going value included in the Company's value was conjectural, uncertain, based on no substantial or specific evidence, and was greatly in excess of the actual cost of establishing such value in the Company's present plant.

The Company's estimate of going value was likewise offered through Mr. Sloan. He had testified on the same point in the 1925 case and also before the District Court for the Northern District of Illinois in the recently decided Chicago Telephone case, where he unsuccessfully claimed an allowance for that item amounting to 15% (I, 268-269).

Before the Commission and the District Court in the present case he put in evidence the same exhibit, which he termed "the cost of establishing the business", on the reproduction theory that the present plant would be scrapped and that the business actually built up over a period of about fifty years would have to be built up again at once. It is perhaps not necessary to point out here how a method, devised merely as one of the guides to the ascertainment of present value of existing property previously acquired, has grown in the hands of utility experts, until it appears as a convenient means of claiming in the rate base intangible elements which never went, and never will go, into the property valued. Of course, this Court has recognized and has stated time and again that there is nothing sacred about the reproduction theory, and has repeatedly warned against the danger of giving weight to pure conjecture. Nevertheless, the flood of fantastic proof goes on unabated.

Mr. Sloan's estimate of the cost of establishing business is summarized (II, 767) as follows:

Carrying Charges during the Development Period on Plant Cut into Service	$4,045,474
Cost of Securing Subscribers	1,665,272
Training Personnel	1,291,832
Development of Forms and Methods	111,875
Initial Directory (1 issue only)	52,040
Total	$7,166,493

Arbitrarily and without being able to describe his mental process or to give any reasons therefor, the witness reduced this figure of $7,166,493 to the lump sum of $4,500,000 as his figure for going value. This amounts to approximately 9% of the Company's inflated estimate of reproduction cost, which we have seen already included overheads amounting to 18.96% of the Company's figure for directly distributed costs.

At the outset it may be noted that the first item of Carrying Charges in the above table is a diplomatic name for hypothetical past losses. Under the law, actual past losses may not be capitalized. "Past losses obviously do not tend to prove present values". *Galveston Electric Company vs. Galveston*, 258 U. S. 388, 395; the *Los Angeles case*, 289 U. S. 287, 313; *Columbus Gas and Fuel Company vs. Commission*, 292 U. S. 398. But Mr. Sloan's past losses are even worse, because they are not actual but suppositious. Whatever actual losses, if any, were incurred, have long since passed out of the present consideration of a rate base, for this Company has been long successful.

With regard to another item in the table, namely, $1,291,832 for Training Personnel, the witness says:

> "Whether considered as training cost, or as cost of the employees for two or three months before you actually began the service, it amounts to about the same thing." (I, 267.)

This indicates that in this item also the witness has in mind the cost of carrying a supposedly idle plant, which is another attempt to capitalize hypothetical past losses. Of this item and other elements, it may be noted, as Mr. Sloan perforce admits, that they have long since been paid for by the subscribers (I, 269). And it may be said:

> "So far as value had been added above the monies thus expended, there was not even approximate precision in measuring its amount."
>
> *Columbus Gas and Fuel Company vs. Commission, supra,* 413.

Thus Mr. Gretz, the Company's Chief Auditor, cheerfully concedes (I, 217), that "It is correct that all of the going value which we have bought and paid for has either been capitalized or it has been paid for out of operating expenses each year as it was acquired". We refer also once more to the apt and forceful language of Judge Rose in the 1925 case, quoted in this brief in another connection (page 63).

Substantial expenditures amounting in some years to more than 50% of total direct labor costs, for items which might properly make up going value, such as officers' salaries, general office clerks, stationery and printing, and certain traffic and commercial expenses, have been capitalized on the books of the Company, and are included in the figures of its historical cost which the Commission trended (II, 873). The Commission recognized this large amount of going value in the figures it allowed, in addition to the separate amount it specifically allowed (I, 66). The Chief Auditor of the Commission suggested that if any additional item for going value is capitalized, a proportionate decrease in future expenses should be imposed, and he computed that this deduction should amount to $200,000 a year if Mr. Sloan's estimate of $4,500,000 is accepted (I, 427-428).

A few illustrations of the way in which Mr. Sloan arrives at these various items will suffice. In his computation of the supposed carrying charges during the development period on plant hypothetically cut into service, but not considered able to pay its own way, Mr. Sloan assumes that in the depth of the depression the carrying charges will amount to as much as 16% (II, 767). To arrive at the supposed cost of securing subscribers, Mr. Sloan assumes that approximately 200,000 subscribers, without telephone service in 1933, would have to be "highpressured" into taking such service by advertising and soliciting at the cost of $8.00 per subscriber (I, 266-267). The great public clamor for service which would undoubtedly be manifest on this hypothesis is utterly ignored. In estimating the supposed cost of training personnel, no proper weight is given to the undoubted fact that there is at present no dearth of trained telephone labor. The supposed initial cost of a directory is likewise included, but no proper weight is given to the possibility that a telephone directory may be issued at a profit.

Mr. Sloan starts out, therefore, with an involved computation totaling $7,166,493, but he arrives at this total only to depart from it, and by a process having no basis in the evidence or in common sense, concludes that going value is $4,500,000. This, according to him, is to be added in addition to the other large overheads and undistributed costs in spite of *Des Moines Gas Co. vs. Des Moines*, 238 U. S. 153, which shows that there is a clear relationship between such overheads and going value. When pressed to explain the procedure which brought him from the premise of $7,166,493 to the final figure of $4,500,000, we submit with all seriousness that the performance was simply ridiculous. See I, 268-269. It is obvious that Mr. Sloan's figure of $7,166,493 is for display purposes only —he gives to "airy nothingness a local habitation and a name."

He points out that the larger figure of over $7,000,000 is about 15% of the reproduction cost exclusive of going value, and that the $4,500,000 is about 8%. He then adds, with perfect seriousness, that he testified to 15% in the *Chicago Telephone Case*, but that the District Court cut his figure to 8%. Because of that experience, perhaps, his computations have changed their name from "cost of establishing business" to "going value". For example, in the 1925 case involving this Company, he named this element "cost of establishing business," and testified to $5,388,000, which was about 16½% (I, 271). In the same case, however, Mr. Robinson, another witness for the Company, estimated $4,324,424 (I, 68) and called it "going value". The District Court in 1925 allowed an amount which came to 3% (I, 269). At I, 269, Mr. Sloan says:

> "I considered also the number of decisions that courts have made. My limit is 15%. There are a few decisions where that has been allowed. There are other cases where it has allowed 7% and 8%, one case 2%."

This reference, added to Mr. Sloan's statement (I, 270), that "I am just offering that as an evidence of what value attaches to the physical property *in addition to its fair worth*," makes it evident that Mr. Sloan is under the impression that in all cases some large item must be added to other costs as a "perfunctory addition."

At I, 279, he further says:

> "One of the guides that guided me was the amount that the Courts have fixed in terms of percentage. That is one of the things I cut my cloth to, and another is the actual expense of obtaining business."

In this subject, as well as in interest during construction and the other hypothetical overheads previously discussed, Mr. Sloan betrays his lack of knowledge and his

indifference to the actual facts surrounding this Company. In Mr. Sloan's "war with realities" there is no armistice. His testimony may be likened to the testimony of certain experts in *Columbus Gas and Fuel Company vs. Commission*, 292 U. S. 398, as to whom Mr. Justice Cardozo said:

> "Other experts, testifying to an aggregate, without assigning a proportion to the contributory factors, give estimates so vague as to be little more than guesses, one of them, for illustration, holding to the opinion that ten would be a fair percentage, yet unable to give a reason why the amount should not be less or greater.
>
> "From the testimony as a whole one gains a definite impression that the opinions are derived for the most part from a professed experience and understanding of business conditions generally, and very little from any knowledge of the 'history and circumstances of the particular enterprise'. *Los Angeles Gas and E. Corp. v. Railroad Commission*, * * * *cf. Houston v. Southwestern Bell Teleph. Co.*, 259 U. S. 318, 325, * * *.
>
> "We cannot find that the Commission and the court went beyond the bounds of a legitimate discretion in putting aside these estimates as too uncertain to be followed."

(J) Conclusion on Company's valuation.

All of these foregoing hypothetical and intricate office studies result in a final figure for reproduction cost new as of December 31, 1932, exclusive of working capital, of $52,711,121 (II, 736). We have seen that the Company had already arrived at a figure of $52,520,522 by the simple application of its specially constructed composite index of telephone construction. It was therefore unnecessary for the Company to resort to this other mass of involved calculations, except to divert attention from the Company's composite index trend, the defects in which

could be so readily exposed by comparison with all other price and construction cost trends. The similarity between the result obtained by the application of the Company's telephone composite index and the result obtained by the detailed office appraisal therefore tends to discredit the appraisal.

But its own composite index, although the trend of its curve compared very favorably with the trend of the United States Department of Labor Building Materials trend through the prosperous years 1924 to 1929, was rejected as too high by the District Court. *A fortiori* it could not be accepted when, after 1929, in conflict with economic laws and in contradistinction from all other price trends of labor and materials (except the trend of Western Electric prices) it artificially remained on higher levels. The detailed office appraisal of the Company must perforce suffer a like condemnation.

X. RATE OF RETURN.

The Court erred in finding "that a return of less than 6% would be confiscatory under present conditions", and in giving no weight to the Commission's allowance of 6%, even though the evidence justified an allowance of 5½% as reasonable and non-confiscatory.

The Commission was liberal in allowing for 1934 a return of 6% on $32,621,190 (I, 77) because the District Court in 1925, in a period of much higher returns generally, had also allowed 6%, which has been acquiesced in by the Company ever since. The Commission in this case indicated, however, that in its opinion "in view of the reduced returns now yielded by businesses of all kinds, and the increased purchasing power of the dollar," the return could properly have been lower (I, 75).

The Company claimed a return of 7½% on $49,722,816 (*Id.* 798). The District Court held that a return of 6% on $39,541,921.27 would not be confiscatory. People's Counsel, representing the ratepayers before the Commission, contended for the allowance of a return of 5½% on a rate base substantially lower than the Commission allowed, and counsel for the Commission before the District Court argued that a return of 5½% on the Commission's fair value of $32,621,190 would not be confiscatory.

The decisions of this Court indicate clearly that there are two legal tests or methods of approach which should be followed in determining a fair rate of return. The first test is a subjective one, concerning itself with the credit position of the particular utility; the second is an objective test, comparing the rate of return in question with returns generally being made, at the time of the rate inquiry, by other comparable business enterprises in the same general locality where the risk to the investors is substantially the same. The opinion of Mr. Justice Butler in *Bluefield Water Works vs. P. S. C.*, 262 U. S. 679, 692-4, and the opinion of Mr. Justice Sutherland in *United Railways vs. West*, 280 U. S. 234, 249-250, furnish clear statements of these two tests.

In the *Bluefield Case* it is said that the utility is entitled to a return (1) "reasonably sufficient to assure confidence in the financial soundness of the utility," and (2) "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . ."

In the *United Railways Case* it was likewise stated (1) that "what may be a fair return for one (utility) may be inadequate for another, depending upon circumstances, locality and risk," and (2) that "the problem is one to be tested primarily by present-day conditions," and judicial notice was taken that "annual returns upon

capital and enterprise, like wages of employees, cost of maintenance and related expenses" had then "materially increased the country over."

It is submitted that, whatever might be a fair return in the form of a percentage for some other public utility at some other time, the evidence in this case would clearly support as non-confiscatory a rate of return in 1933 and 1934 of no more than 5½% upon the Commission's fair value for this Company. The present application to this Company of both of the tests alluded to above establishes this, and we contend that this generosity of the Commission, in giving the Company a return one-half per cent. higher than it need have done (in dollars amounting to $163,105), may be taken "to supply a margin for the correction of other contested items that may approach the border line," if any, and should be considered in determining whether the action of the Commission in its totality constituted a denial of due process.

(a) The evidence shows that a return of 5½% would support the Company's credit and enable it to attract all necessary capital.

Even if this Company might be regarded as an enterprise standing alone without financial support and help from its powerful parent company, the nature of its own peculiar history and financial position and the circumstances surrounding it are such, that with 5½% return in times like these it would have no difficulty in attracting all the capital it may need. Under depression conditions it is of course difficult to attract from investors large amounts of capital for risky enterprises or for totally new and untried ventures. But the realities of the situation must not be permitted to escape us. The Company's particular business is 50 years old and is neither unsound nor untried. Furthermore, to be realis-

tic, we must not lose sight of the fact that the Company is in no need of attracting large amounts of capital even from the A. T. & T. at this time. It has no bonds outstanding and therefore no maturities to refund, and it will not be under the necessity of obtaining any substantial new funds for increasing its plant, because, as we have seen, it now has an enormous amount of excess capacity available.

Again, this Company is the most successful from an earnings standpoint (on the basis of gross cost) of all the wholly owned A. T. & T. telephone companies operating where public regulation obtains (II, 918). Among all the Bell companies it ranks in the first three. It would be hard to frame a more attractive proposition to a prospective investor than to permit him to lend a substantial amount of money to this Company. But such a proposition could not be made to him; the general investor is excluded from this opportunity, the A. T. & T. insisting upon the privilege of supplying the Company with all of the capital that it needs.

Even in times when, with confidence shaken, we have become accustomed to regard as hazardous many investments which are even now intrinsically sound and which would be unquestioned in prosperous times, it would be taxing one's imagination to conjure up anything connected with this investment which could properly be considered risky. If any investment can now be regarded as reasonably safe, an investment in this Company certainly can be. The investor could take into account the high stable earnings which this Company has enjoyed over a long period of years, and the fact that the Company's income has relatively declined very little, even during four years of the worst depression in history; that it has not suffered to anything like the same extent as industrial enterprises; that it possesses a complete, protected monopoly in furnishing a business necessity

to one of the richest territories in the United States, thereby escaping the costs and risks attendant upon seeking business in a competitive market; that its principal is safe; that it is efficiently managed; and that it has thrived and prospered under wise and sympathetic state regulation administered by a Commission which, since 1910, has never until this case ordered it to make a reduction in rates, but which on three separate occasions has permitted it to increase its rates, and which, even in the case at bar, has allowed to it the full of all its claimed operating expenses without question, except the item of depreciation.

Attention could also be called to many other inducements and attractive features, including the fact that from 1925 to 1932, inclusive, it has more than doubled its unallocated surplus and, at the same time, has paid 8% annual dividends upon its common stock, and that its $3,000,000 of preferred stock, paying a 7% dividend, was issued to the public at a premium, and during the depression has been selling substantially above its call price of 110.

The investor could take into account that 6½% return on the rate base found by the Commission would yield enough to cover all interest requirements on the small amount of money which the Company borrows, continue the payment of the 7% dividend upon the preferred stock, and permit the Company, without dipping into its surplus, to pay dividends of almost 6% upon all of its common stock,—a dividend comparing favorably with returns generally earned in the depth of the depression. (See Appendix for 1934 figures.)

But for the purpose in view it is not necessary under the law to view this Company as though it were isolated and unaided. It is owned, body and soul, by the largest and richest private corporate in the world which, in addition to its natural inclination as owner, is further

induced to aid and finance this Company by receiving annually from it 1½% of its gross revenues to cover the cost of rendering financial and other assistance, the whole of which payment has been allowed to this Company as an operating expense.

Numerous cases decided by this Court have indicated that the advantages which come from such an affiliation may properly be taken into account by the body intrusted with ratemaking powers. For instance, in *Wabash Valley Electric Company vs. Young*, 287 U. S. 488, 501-502, the opinion by Mr. Justice Sutherland, when discussing the rate of return, alludes to the fact that the company there involved was one "whose financial structure, it fairly may be assumed, is greatly strengthened by its affiliations and by the interested support of the parent company to which it belongs". And he also says: "It is reasonable to conclude that appellant is in a more favorable financial condition than if it were a disconnected enterprise."

Again, in *Smith vs. Illinois Bell Telephone Company*, 282 U. S. 133, 161, this Court, dealing with the rate of return appropriate for one of this Company's sister companies, says through the Chief Justice:

> "It is evident that in the present case we are not dealing with an ordinary public utility company, but with one that is part of a large system organized for the purpose of maintaining the credit of the constituent companies and securing their efficient and economical management."

And by analogy in *Dayton Power and Light Company vs. Commission*, 292 U. S. 290, 310, this Court, dealing with organization or preconstruction costs there claimed, states, "The appellant's position as a member of an affiliated system would have a tendency to reduce such expenses to a minimum."

The Company's Exhibit A-41 (II, 795) purports to show the cost to the A. T. & T. of funds used in its business in the year 1933. The statement shows on its face an equated cost of 6.59%. In order to arrive at such a high percentage for the cost of funds, however, the full 9% dividend paid was included. Such a computation sheds little light upon the problem, because if the Company had paid a 20% dividend, the average rate as shown in the exhibit would have been increased very substantially, whereas if it had paid no dividend at all, the rate would have been decreased tremendously. Thus the dividend paid is not a fair criterion of the cost of money. The only proper computation of the cost of money would involve the substitution of a reasonable rate of dividend for the actual dividend. The determination of a reasonable dividend, of course, must take cognizance of the relative prosperity and the yield or return on money generally at the time of determination. The year 1933 was so notoriously a year of business depression and a year of low yields and returns generally on investments, that it would be presumptious to attempt to argue otherwise. A 6% dividend in lieu of the 9% dividend actually paid would therefore appear to be the maximum warranted during 1933. Such a dividend would reduce the so-called cost of money to the A. T. & T. from $193,457,217 to $137,470,392. The average rate for the cost of money would consequently be reduced from the 6.59% shown in the exhibit to 4.69%.

It is well known, and a proper subject of judicial notice, that the cost of money to sound public utilities and other sound businesses has drastically declined in recent years. Savings bank interest rates in Baltimore, Maryland, had declined from 4½% in 1929 to 3% in 1933; Federal Reserve rates on Rediscounts from 4½%-6% to 2%; New York open market rates on Prime Commercial Paper from 5¼%-6¼% to 1¼%-1½%; on

Prime Bankers' Acceptances from 8¾%-5½% to ⅝ of 1%; on Time Loans from 4¼%-9% to ¾ of 1%-1¼%; on Call Loans from 4.88%-9.8% to 0.94%; Interest on Treasury Bonds from 3.46%-376% to 3.62%; Interest on United States Treasury Notes from 3.05%-5.09% to 0.29% (II, 919).

On Exhibit D-12 (II, 896-897) are shown the yields in percentages upon public utility bond issues floated in the first months of 1933 and from July 1 to December 31, 1932. The exhibit clearly shows that, even in the darkest days of the first three months of 1933, public utility companies, certainly no better situated than this Company, were able to obtain substantial amounts of bond money at low yields. Attention is specifically directed to the fact that the Consolidated Gas Electric Light and Power Company of Baltimore, a company no more highly regarded as a business risk than the Company in the case at bar, issued for refunding purposes in February, 1933, $5,000,000 of bonds at a yield of 4.12%, which was the lowest yield in its history. The weighted average yield of all the public utility bonds issued during this period and listed by the Annalist was 5.61% (II, 897). The bond issues aggregated $346,863,000. Thus there are ample funds available at very low rates to sound public uitlities, such as this Company.

(b) The evidance shows that a return of 5½% would compare favorably with returns being made at at the same time by other enterprises attended by corresponding risks.

When we come to apply the second test prescribed by this Court for the determination of a fair rate of return, we find the propriety of allowing a 5½% return for this Company would be amply substantiated. It is notorious that the returns made by almost all businesses, where their returns have not disappeared altogether, have markedly declined during the depression.

In Exhibit D-12 (II, 897-907) appears a study of 296 corporations listed on the New York Stock Exchange, disclosing those which suffered losses in the year 1932, and showing the percentages of profit for those which earned profits. The corporations listed were all of those for which the information could be obtained when the exhibit was compiled. They were not hand-picked, but were selected quite largely from Moody's Manual.

It appears from the summary of the exhibit (II, 907), that 53.04% of those companies sustained losses, and 72.32% of them earned less than 6% upon plant and inventories. Of those which earned more than 6%, enterprises such as tobacco companies and companies with patented processes and formulas, or which manufacture specialty products, predominate. It should be noted, too, that the corporations listed in this study are the leading corporations in the United States—those which can meet the requirements of the New York Stock Exchange. Similar information is given in Exhibit D-12 for railroad corporations listed on the New York Stock Exchange (II, 908-909). Out of 48 such corporations only one had a return of more than 6% upon plant and inventories, and approximately 23% of them sustained losses. Exhibit D-12 also shows the relationship between the industrial corporation profits for the years 1931 and 1932, and it discloses that whereas the corporations listed had an average return of 3.3% in 1931, they had an average loss in 1932 (II, 911-912).

Exhibit D-12 also presents a most relevant study comparing the per cent. of return on plant and equipment earned in 1932 by the twenty-one Bell Companies associated with the A. T. & T. (II, 918). On undepreciated cost as a base, none of the companies earned as much as the 7½% return which the Company asks in this case. The three companies showing the largest returns were Diamond State Telephone Company, an unregulated

company serving the state of Delaware, 5.88%; Cincinnati and Suburban Bell Telephone Company, which the A. T. & T. does not control, 5.19%; and the C. & P. Telephone Company of Baltimore City, 5.67%. The other eighteen Bell Companies range down to 2.48% (Wisconsin); the weighted average of all twenty-one is 4.43%. It is significant that the Illinois Bell Company, *prior to the reduction sustained by this Court in the Lindheimer Case*, earned 4.0%, and stood seventeenth among the twenty-one companies.

On cost less depreciation reserve, C. & P. Telephone Company of New York in 1932 earned 7.02%; Cincinnati and Suburban Bell Telephone Company, 8.2%; and C. & P. Telephone Company of Baltimore City, 7.13%. Thus, among the companies which are both controlled by the A. T. & T. and are subject to commission regulation, the Maryland Company stood *highest* on either basis. As all the Bell companies are operated in almost exactly the same manner, this is very persuasive circumstantial evidence that the Maryland Company is not being persecuted.

It would also seem hard to understand, on this comparable basis, how the Illinois Commission, as a practical matter, could be sustained in reducing the Illinois Company below 4% on gross cost, unless it is also proper for the Maryland Commission to order a reduction below 5.67%. The assumption that the gross costs of the two companies are in the same proportion as fair values is reasonable; we assume merely that additions were uniformly made at comparable price levels. Of course, the comparison is only circumstantial evidence, but it is a stubborn circumstance for this Company to explain away.

The witnesses for the Company claimed a rate of return of 7½%, but it is apparent from their testimony that they were giving a percentage which they thought would be appropriate as an average percentage over a

period of years, *including the years of high returns in the immediate past*, and that they were not testifying to a rate of return which would be specifically appropriate for 1934. As to this, Mr. Crunden, the Assistant Comptroller of the A. T. & T., testified (I, 360):

> "It seems to me that we have got to distinguish between what is a fair return over a reasonable span of time, and what you would adopt as a standard for testing the thing at a particular moment of time, which might be at any stage in the business cycle, and if you are going to do that, I would expect to find that rates had been set at a reasonable level in times when you were not in one of those peculiar conditions."

And on cross-examination he testified that, if he had been testifying as to the proper rate of return in any rate case that arose in 1928 or 1929, "I would have advocated for those years, for a company like this, a rate of return of about the same, that is, 7½% to 8%." (I, 362.)

Mr. Boyce likewise on cross-examination said: "When I say 7½% return, I mean over a period of 10 years on the fair market value." (I, 372.)

But under the law, we submit, rates of return as well as rate bases fluctuate with economic conditions. Rates of return commonly allowed during the post-war period up to 1929 may not be used as safe criteria for determining the lower rates of return which should be allowed today. It is hard to understand how, if a rate of 6% was proper and was acquiesced in by the Company in 1925, 5½% could be confiscatory in 1934 under the clear rule announced by the cases. In pre-war times of lower price levels, 6% returns were generally held non-confiscatory.

Willcox vs. Consolidated Gas Company, 212 U. S. 19, 48, 50;

Cedar Rapids Gas Light Company vs. Cedar Rapids, 223 U. S. 655;
Des Moines Gas Company vs. Des Moines, 238 U. S. 153.

With the rise in price levels incident to the war, came also the constitutional requirement of higher rates of return, and now, with the coming of bad times, we find quite generally in the cases the indication that considerable decreases in the rates of return should be made. For instance, in 1926, in *McCardle vs. Indianapolis Water Company*, 272 U. S. 400, a 7% return was held proper at that high period. The same company, however, has recently been involved in rate litigation, and in *Indianapolis Water Company vs. McCardle*, P. U. R. 1933 B, 222 (not reported in Federal System) the District Court concluded that a rate of return of 6% under the conditions existing in 1932 would not be confiscatory.

In *Kankakee Water Company vs. Gilbert*, P. U. R. 1933 B, 145 (not reported in Federal System), decided January 6, 1933, the District Court held 5.17% non-confiscatory. In *Illinois Bell Telephone Company vs. Gilbert*, 3 F. Supp. 595, the Statutory Court approved a rate of return of 5½% for 1932 for this Company's less successful sister company.

In *West Ohio Gas Company vs. Commission*, 55 Sup. Ct. Rep. 316, decided January 7, 1935, this Court, through Mr. Justice Cardozo, indicated that if the return there for 1928-1933 had been 5.75%, it would not have been confiscatory, but that 4.53% was "too low a rate to satisfy the requirements of the Constitution when applied to a corporation engaged in the sale of gas during the years 1928 to 1931, two at least of the four years being before the days of the depression." Mr. Justice Stone, concurring in the action of the majority, remarked:

> "I am not prepared to say that petitioner sustains the burden of showing confiscation, by show-

ing a rate of return even as low as 4.91% where it is upon reproduction value determined as of March 31, 1928. We judicially know, and cannot ignore, the large declines in price levels and the earnings of capital which have taken place since that date."

We again call this Court's attention to the fact that the District Court in the case at bar indicated that anything less than 6% upon depreciated historical cost, historical cost being the equivalent of the Company's reproduction cost at 1929 prices, would be confiscatory for this Company. This we contend was clear error, in the light of the cases above cited.

(c) The Court erred in failing to give any weight to the effect of the decrease in general price levels which increased the purchasing power of the dollars of current net return as contrasted with the purchasing power of the same number of dollars prior to the depression.

It is clear that the return to which the Company is entitled must be fair in terms of purchasing power, that is, "real" income. In discussing the Commission's approach to present value we have referred to this truism (page 50). The concept of "real" income strongly confirms, if it is not the true basis for, the rule of a rate of return varying with general conditions. In this case, since 6% was allowed in 1925 and the same rate is allowed for 1934, a clear comparison can be drawn without elaborate adjustments. If a 6% return represented a certain purchasing power in 1925, in 1934 the same number of dollars plainly represented far greater purchasing power. Thus, in refusing to reduce the rate of return to 5½% or lower, the Commission has actually *increased* the return in terms of purchasing power, and those terms are

the criterion of confiscation. Mr. Smith prepared studies to measure accurately this increase in real income; see his testimony at I, 447-450, and the statistical data at II, 890-5, which are highly significant.

(d) The Court erred in failing to give any weight to the fact that the subscribers to telephone service, because of decreased income, are now paying a larger proportion of such income for such service as compared with the period prior to the depression, the said rates being the same in dollars.

There is another reason why fair real income must be the final goal of rate-making. The Company's subscribers must pay for their telephone service out of *their* income. If charges for such service remain the same in dollars, the subscribers are paying a higher proportion of their present reduced incomes for service (I, 306-7). This factor of ability to pay for service is surely part of the definition of "fair" value and "fair" return. Rates, expressed in rate of return, must be fair to stockholders, but there are two parties to the definition; the rates must be fair to stockholders in the light of the subscribers' current and collective circumstances.

The Company's witness, Dr. King, summed up the vitally practical importance of the purchasing power of the dollar when he said, "making it personal to me, if I had any choice I would decidedly prefer to have a salary of $50,000 in 1933 than the same salary in 1929." (I, 310.) So, also, the 6% rate, under which the Company has prospered so splendidly, is worth far more in 1934 than it was in 1925. Yet the Commission did not reduce the 6% rate. Its unwillingness to do so must be weighed in its favor on the issue of confiscation.

XI. CONCLUSION.

The one issue before this Court is whether the Company has proved before the District Court, by evidence too strong to be rejected, that the Commission's order necessarily results in confiscation. We have shown on this issue the following vital and significant factors:

The Commission made its findings after most mature deliberation, following a hearing of 41 days during which the Company was given every opportunity to, and in fact did, present all of the evidence and arguments it saw fit. The Commission's opinion is exhaustive and clear, and indicates not only the care and deliberation with which the result was reached, but shows that the Commission is competent and experienced.

To attack that order as unconstitutional, without even waiting for a test period under the proposed rates, the Company offered with all solemnity evidence which, if true, indicates that the Company has acquiesced in confiscation for 9 years, and now, to preserve its constitutional rights, must have $1,200,000 *more* in net revenues for 1934 than it had in 1933 under existing rates, although the Company's prosperity during those 9 years has been phenomenal. The mere statement of the practical purport of such evidence utterly discredits its application to the issue of confiscation. "Proving too much, they fail of the intended effect." Detailed analysis of such evidence discloses, in physical appraisal, erroneous and arbitrary assumptions; and conjectural and absurd claims for intangible values based on irrelevant, almost incoherent evidence by an outside engineer, whose attempts to rationalize his estimates were fantastic. The Company's other evidence of value was of costs incurred in a period before the present tragic depression had produced its "new experience to the present generation", whose major feature is depressed values.

We have shown that the District Court, heedless of the Chief Justice's pronouncement in the *Lindheimer Case*, that "It is not the function of the court to attempt to construct out of this voluminous record independent calculations to invalidate the challenged rates", pursued its independent calculations, item by item, and arriving at different results from the Commission, felt itself bound automatically to hold the order invalid because of that difference. In so finding, the District Court expressly misconstrued its function by a mistaken view of the *Ben Avon Case*, a view palpably contrary to the Chief Justice's statement just quoted, and other clear rulings of this Court.

The District Court expressly stated its preference for rigid prudent investment to the established law of fluctuating fair value, and so found, as its independent and substituted value, a figure of book costs less depreciation (down to the last twenty-seven cents), in spite of notorious common knowledge and overwhelming, specific evidence that current values of all kinds are far lower than the costs in the period during which the property was installed.

The District Court's independent, substituted findings for depreciation expense and for working capital were $2,000,000 and $1,000,000 respectively, whose very nature as round figures strongly suggests, as indeed has been demonstrated, that they were not built up on specific evidence, but were mere compromise guesses. The District Court's own language in discussing depreciation expense reveals expressly that it did not itself believe that the Company's evidence was compelling or clear; yet on this subsidiary fact the Commission's judgment, which it was "at liberty to form", was arbitrarily tossed aside, again in reliance on a mistaken duty to construct out of the record independent calculations to invalidate the Commission's considered judgment. This the District

Court did, and accordingly branded the Commission with unfairness, even though between the Court's finding of fair return of $2,372,515, and the Commission's allowance of $2,353,793, there is a difference of only $18,722, which is in terms of dollars (not rate) a difference of only eight-tenths of 1%.

We have shown that the Commission in finding value used a method which gave full effect to costs when incurred, and brought such costs to present levels by a carefully weighted index which reflects the earning value in present dollars, thus reconciling the great advantages of prudent investment with the law of fair value. In so doing the Commission followed the example of Circuit Judge Rose, whose grasp of economic facts was near to genius; and the Commission, furthermore, had before it many confirming indices, special and general, which the District Court in 1925 did not have.

The Commission liberally allowed in the rate base very large values of a plant which is far in excess of the demands of the present reduced number of subscribers. It allowed, too, very liberal operating expenses, based on the incredible increase in Western Electric prices since 1929, and the Company's very high labor rates. None of these liberalities did the District Court weigh in the Commission's favor, although they would represent many millions in rate base, or several hundred thousand dollars of income.

We have shown that the District Court ignored utterly the large specific margin of nearly $400,000 of return allowed by the Commission to give the Company the benefit of all hope, or doubt, as to increases in prices after the Commission's determination.

The Commission and District Court both allowed 6% as a fair rate of return, notwithstanding the mass of evidence, from every approach, that 5½% would be fair and reasonable.

In conclusion, we believe it has been shown that the Commission acted maturely, fairly, and generously; that the Company's "elaborate calculations" are "at war with realities" and hence fail of their intended effect, and cannot therefore, under the admitted circumstances, be sincere on the issue of confiscation; and, finally, that the District Court approached its deliberations under a misapprehension of its constitutional function, and that it substituted its judgment gratuitously and erroneously for that of "the appointed triers of the facts", and reached independent findings which were clearly and demonstrably contrary to established law and admitted facts.

We therefore respectfully contend that the decree of the District Court, enjoining the Commission's order, must be reversed.

Respectfully submitted,

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